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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2015-2016

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith an overview report on the economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States) for the period 2015-2016.

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Economic situation in the Economic Commission for Europe region (Europe, North America and the Commonwealth of Independent States), 2015-2016

Summary

The present report considers the economic performance of the countries of the Economic Commission for Europe region in 2015 and early 2016 and future prospects. While moderate expansion was observed in the European Union and particularly in the United States, the decline in oil prices compounded other debilitating influences in the Commonwealth of Independent States and resulted in a decline in economic activity. Differences in the strength of the recovery led to divergent monetary policy stances in the United States and the euro area. Falling oil prices in the Commonwealth of Independent States led to significant exchange rate volatility. Economic prospects in the Economic Commission for Europe region remain mixed amid significant downside risk factors.

I. Introduction

1. The Economic Commission for Europe (ECE) region includes 56 member States, with very different development levels and economic situations. It contains most of the world's advanced countries, but also a number of lower-middle income economies. For analytical purposes, the present report will divide this large and diverse number of countries into different subregions and group them into two major categories: advanced economies and emerging economies. Advanced economies include: (a) North America, composed of Canada and the United States of America; (b) the countries that are part of the euro area; and (c) other advanced European economies. European emerging economies include: (a) new European Union member States that have not yet joined the euro area; (b) non-European Union countries in South-Eastern Europe, including Turkey; and (c) countries belonging to the Commonwealth of Independent States and Georgia.

II. Overview

2. Growth in ECE member States slowed to 1.6 per cent in 2015, down from 1.9 per cent in 2014. Economic performance was very diverse. While in the United States and the European Union a moderate recovery continued, the adverse trends observed in the Commonwealth of Independent States in late 2014 became stronger and sluggish growth was followed by an outright contraction of output. The decline in oil prices, which almost halved, affected energy-exporting and importing countries differently. This was a major factor explaining the diversity of economic performance in the ECE region. Lower oil prices also negatively affected investment in the energy sector in advanced countries. Output in the Commonwealth of Independent States is expected to shrink for a second consecutive year in 2016, amid further deterioration of the terms of trade, albeit at a more moderate pace. No major changes are envisaged in the United States and the European Union in 2016, with economic expansion projected at similar levels.

3. In the United States, job creation has been fast but wage growth has only recently picked up. By contrast, in the euro area, unemployment levels remain high in many countries, despite some improvement. In the Commonwealth of Independent States, the labour market has been relatively resilient, given the scale of the decline in economic activity, but unemployment has increased and remittances, which are sizeable in the poorest economies, have shrunk sharply.

4. The improvement in labour markets and easier financing conditions have boosted housing prices and residential investment in some advanced countries. However, overall investment has remained relatively weak amid lingering concerns over the strength of global demand, bouts of financial turbulence and, in some countries, still high levels of indebtedness.

5. A more sustained and robust recovery in the United States than in the euro area has been reflected in the divergence of monetary policies. While the United States Federal Reserve increased rates in December 2015 after seven years of no change, the European Central Bank announced further easing measures in March 2016. Past expectations concerning the direction of monetary policy drove movements in exchanges rates, with a sharp appreciation of the United States dollar in 2014 that dampened recent export performance. In the Commonwealth of

Independent States, large exchange rate depreciations have taken place, as the shocks in energy-exporting countries have been transmitted to other economies in this subregion. In early 2016, some recovery in commodity prices was accompanied by currency strengthening.

6. The different role of fiscal policy in supporting the recovery after the 2008-2009 financial crisis in the United States and the euro area contributes to explaining the differences in economic performance in recent years. In the euro area, past tighter fiscal policy has now been replaced by a more relaxed stance. In a number of European Union countries, the refugee crisis has been a source of additional fiscal outlays. In the Commonwealth of Independent States, energy exporters were forced to undertake significant fiscal adjustments, as oil prices were expected to stay low for a long time.

7. There are a number of risks that cloud the horizon. Geopolitical tensions, which have disrupted trade and undermined confidence in the Commonwealth of Independent States, have not yet disappeared. The refugee crisis, while providing a short-term boost to economic activity, is creating strains in a number of European countries. A decision by the United Kingdom to leave the European Union following the referendum scheduled in June 2016 would represent a significant shock and would add to the existing uncertainty.

8. Overall, medium-term growth prospects are being undermined by a number of factors that require policy attention. Ageing will reduce labour supply and therefore growth potential. Large and persistent unemployment levels in some countries not only erode social cohesion but can become entrenched through skill deterioration. Productivity growth has been weak in the aftermath of the financial crisis and current investment levels do not bode well for a significant acceleration. The current predicament of energy-exporting countries shows the need for economic diversification, but this would require, among other things, an investment effort which is at odds with the depressed trends being observed. The multiple challenges faced would need to be addressed by a comprehensive mix of policies that offsets demand weakness, in particular in some countries, but also tackles structural factors undermining growth.

III. North America

9. Despite a disappointing beginning of the year, economic growth remained relatively strong in the United States in 2015, with GDP posting a 2.4 per cent increase, unchanged from 2014. Consumption was well supported by dynamic housing and labour markets and low energy prices. Household debt as a percentage of disposable income, and the cost of servicing this debt, have continued to fall. Given these favourable conditions, private consumption, which accounts for more than two thirds of GDP in the United States, rose by 2.6 per cent in 2015, the fastest rate in a decade. Consumption is expected to provide continued impetus to economic expansion, as these supportive factors are likely to persist.

10. Investment benefited from low oil prices and stronger domestic demand, with the notable exception of the energy sector. By contrast, construction performed particularly well, soaking up pent-up demand and being supported by an acceleration in the rate of household formation. Residential investment grew by 8.7 per cent, the fastest rate of all demand components. Business fixed investment

increased by only 3.1 per cent. Overall, investment has remained weak in the post-crisis period, being well below historical trends, and slowed down in 2015.

11. Net external demand made a negative contribution to growth amid a deteriorating external environment. The trade-weighted United States dollar rose by 10 per cent in 2015 and this appreciation, which is rather large by historical standards, was accompanied by a weakening of demand in some key markets. This resulted in very slow growth in exports. While the current account deficit has been declining, it is still large, reflecting the relative strength of United States demand as compared with the rest of the world.

12. The labour market showed increasing signs of dynamism in 2015, ending the year in a strong note. The worst performer in an overall bright picture was the mining sector, as cuts in oil-related employment led to sizeable job losses. By the end of 2015, non-farm employment was 3.5 per cent higher than at the start of the recession. Unemployment ended the year at 5 per cent, down from 5.6 per cent one year earlier. Long-term unemployment also declined but remained above the pre-crisis average. Broader measures of unemployment, which also consider involuntary part-time occupation, also showed some improvement. These positive trends have continued in early 2016, despite some concerns about economic slowdown.

13. The labour participation rate has been declining since 2000, but this trend accelerated in the post-crisis period. This largely reflects demographic factors but also lower participation rates in some population groups, in particular less educated men, who are retiring from the labour force. However, the participation rate has been picking up since late 2015 as the recovery pulls in new workers. In March 2016, the rate was around 4 percentage points below the peak observed in late 2000.

14. The current economic recovery has been relatively job-rich but wage-poor. Despite sustained economic expansion and unemployment approaching levels close to what could be considered full employment, wage increases have been modest. Nominal average wages were growing at an annual rate of 2.5 per cent by the end of 2015, which was well above inflation and an improvement over the previous year. The continued output recovery should support the acceleration of wage growth. Falling unemployment has boosted consumption, but this effect can be expected to fade away as the economy approaches full employment if not followed by increased wage gains.

15. As a result of low oil prices and a strong dollar, inflationary pressures remain absent, with the consumer price index growing by only 0.7 per cent by the end of 2015. Implicit inflation forecasts from the bond market suggest the absence of price pressures. However, the personal consumption expenditure price index, excluding volatile components, which is the preferred inflation measure used by the Federal Reserve, has been climbing steadily since late 2015. Even if labour costs pick up, as slack disappears, inflation is unlikely to make a strong comeback, given the behaviour of import prices.

16. Fiscal policy is becoming increasingly supportive of growth. In 2015, the federal budget deficit fell 0.3 percentage points, coming down to 2.5 per cent of GDP, but this was the result of growing revenues, as economic activity increased. Overall, public finances made a positive but modest contribution to growth. Tax breaks will reduce projected 2016 revenues and the budget deficit is expected to increase as a percentage of GDP for the first time since the financial crisis, reaching 2.9 per cent, according to Congressional Budget Office.

17. The outlook for monetary policy in the United States remains quite different from that in other advanced economies. Expectations of divergent policy stances, with the United States widely believed to reduce monetary policy accommodation, have underpinned the strengthening of the dollar since 2014. The Federal Reserve increased the target range for the federal fund rate by 0.25 percentage points in December 2015, which was the first change in seven years. This movement had been largely anticipated, though it was initially expected to occur earlier in the year. The prospects of monetary policy tightening in the United States have contributed to harsher financial conditions in emerging markets, amid declining capital flows and exchange rate turbulence. However, rapid tightening seems increasingly implausible in view of renewed concerns over growth and the dampening effect of a strong dollar on inflation. While the labour market remains dynamic, the external environment has become more challenging and monetary authorities in other advanced countries have signalled an easing bias.

18. The continued strength of the United States economy contrasts with concerns on a global slowdown driven by China and other emerging markets. The United States is a relatively closed economy, where exports of goods represented around one eighth of GDP in 2015. But the indirect impact of a worsening external environment can be larger than this ratio would suggest, as financial turbulence and increased risk aversion have damaging implications for investment. The tumultuous start of the year in financial and commodity markets in 2016 has been followed by some stabilization, but renewed turbulence in the world economy could also take its toll on the United States.

19. The United States economy, like other advanced economies, is facing lower labour productivity growth in the post-crisis period. Job gains have been faster than increases in output. Persistent low investment holds back productivity increases. While investment is expected to pick up, as the recovery takes hold, drivers of total productivity growth deserve increased policy attention in order to support sustained income gains.

20. In Canada, economic expansion decelerated abruptly in 2015, with the rate of GDP growth more than halving to 1.2 per cent. This was the slowest rate since the 2009 recession, reflecting the impact of falling oil energy prices. Fixed investment fell sharply, reducing the growth rate by one percentage point. Consumer demand fared better, but job losses in the energy sector, the weakening of the Canadian dollar and record levels of household debt led to moderate growth. A depreciating exchange rate resulted in a stronger net external demand that offset domestic weakness. The good performance of exports continued in early 2016, being driven also by increasing demand from the United States, a major commercial partner. Growth will be supported by fiscal stimulus measures in 2016 but will remain very dependent on external factors. Moderate productivity increases and an ageing workforce undermine future expansion.

IV. Advanced European countries

A. Euro area

21. The euro area recovery gained momentum in 2015, although growth remained modest despite a rather favourable external environment during most of the year. Growth was the fastest since 2011, with GDP posting a 1.6 per cent increase, up from 0.9 per cent in 2014. The pre-crisis output level was finally reached in the first

quarter of 2016. Overall, performance in the euro area has been driven by the combination of four positive factors: the impact of past exchange rate weakness, easier financial conditions, looser fiscal policy and lower energy prices.

22. Domestic demand has played an increased role in the recovery in the euro area, amid a more supportive policy environment. Consumption, in particular, has driven the acceleration of growth. This reflects gains in real disposable income, boosted by improved labour market conditions and falling energy prices. Although consumption is expected to remain strong in 2016, more adverse external conditions and still insufficient progress in reducing unemployment in a number of countries cast some doubts on the future dynamics of consumption.

23. The rebound of investment has remained elusive, reflecting continued uncertainty on the outlook for demand and lingering effects from the crisis, including high levels of debt and unemployment. Sluggish investment means current lower demand and therefore weaker growth impetus, but it has also supply implications for future expansion, as it reduces the potential stock of capital and has negative implications for productivity.

24. Investment rose by 2.3 per cent in 2015, up from 1.3 per cent in 2014. Investment did not appear very sensitive to financing conditions and lending did not increase faster in countries where rates fell more rapidly. Easier financing conditions have facilitated deleveraging and debt refinancing, while lower oil prices have been positive for corporate profitability. Funding to corporates has improved but remains weak in comparison to other business cycles, in line with still subdued investment demand. The Investment Plan for Europe, an initiative of the European Commission, will support infrastructure and innovation spending, with around 80 billion euros in expected investment reached in early 2016. However, this is still little in comparison to a target of 315 billion euros in 2015-2017.

25. Lower funding costs and energy prices should support further acceleration of investment, following increases in capacity utilization and the improvement of corporate margins. Housing starts below the rate of household formation also suggest a pickup in residential investment as house prices recover. However, economic uncertainty may offset these positive factors, thus undermining the sustainability of the recovery.

26. The competitiveness of the euro area has improved and exports have increased faster than overall world trade since 2014, although with significant disparities among countries. For example, Spain increased its share of exports both within and outside the euro area, in contrast with the declines observed in Italy and, in particular, France. After a strong start and despite the depreciation of the euro, export performance deteriorated in the second half of 2015 as the external environment worsened. Countries with stronger relations with the Russian Federation have suffered the impact of sanctions and counter-sanctions and the contraction of economic activity in that country.

27. Overall, net external demand had no impact on growth in 2015. In Germany, the largest economy in the European Union, net external demand contributed only 0.2 percentage points of the 1.7 per cent increase in GDP observed in 2015. Net external demand is likely to have a small but negative contribution to economic expansion in 2016. The strengthening of domestic demand, which will suck in imports, is taking place in a more adverse global environment.

28. Labour market conditions have improved, driven by the continued recovery in a context of moderate wage increases. Job creation has been relatively fast considering the still modest output growth. The unemployment rate declined to 11 per cent in 2015, thus remaining 2.5 percentage points above pre-crisis levels. This aggregate figure masks significant differences, with unemployment remaining very high in some countries. Labour market reforms have brought increased flexibility but employment growth has often been dominated by low quality jobs. Despite the persistence of unemployment, activity rates have been resilient and the trend of growing labour market participation has continued. The existence of high youth and long-term unemployment points to entrenched social problems and negative impacts on potential output. In particular, the share of youth unemployment in total unemployment has increased since mid-2015.

29. The environment of extremely low inflation persisted in 2015. Prices declined in a number of countries and aggregate inflation ended the year at a mere 0.2 per cent. While falling energy prices had a significant effect on overall dynamics, core inflation remained subdued, with a 0.9 per cent increase. These trends continued in early 2016, with no annual price change in March. Inflation may stay low for longer than anticipated owing to the influence of soft energy prices, the persistence of stronger but still weak demand and, despite some recovery in labour markets, low wage growth. Continued undershooting of inflation projections suggests the presence of significant slack in the economy. Declining inflation expectations contribute to increased real interest rates and make more difficult debt servicing, thus resulting in tighter financial conditions.

30. The current account surplus rose from 2.4 per cent of GDP in 2014 to 3 per cent in 2015 as a result of the combination of falling oil prices, a weak exchange rate and a moderate increase of domestic demand. The rebalancing of intra-euro current account balances has been driven by peripheral countries, as a result of weak domestic demand and somewhat improved external performance. However, little adjustment has been seen in countries with large current account surpluses. Germany's surplus with the euro area has disappeared and its large current account surplus is almost fully explained by the positive balance with the rest of the world.

31. Unlike in the United States, fiscal policy has not been supportive of the post-crisis recovery. However, there was a general relaxation of the fiscal policy stance in the euro area in 2015. In some countries, this has been linked to the arrival of large inflows of refugees and its impact on expenditures. Germany has been the main destination, absorbing some 1 million people, but Austria and, outside the euro area, Hungary and Sweden, have also received a large number of asylum applications. Associated moderate fiscal expansions in recipient countries have given a modest impulse to growth. European Union fiscal rules under the Stability and Growth Pact provide for flexibility to accommodate this increased expenditure. In relative terms, as a percentage of GDP, refugee-related fiscal costs have been particularly large in Denmark and Sweden, both outside the euro area.

32. Over the medium-term, the potential increases in the labour supply could have more sustained effects on economic activity, but this depends on the success in integrating the newcomers in the labour market. Although a number of countries have taken measures to restrict or discourage further inflows, the geopolitical situation suggests continued pressure.

33. Despite this fiscal relaxation, the general government deficit fell to an estimated 2.2 per cent of GDP in 2015, as the pickup in growth boosted revenues and the cost of servicing the debt fell. The persistence of low interest rates for long periods is increasing fiscal space in indebted countries. For highly-rated countries, the movement has been more dramatic: the average yield across German government bonds declined to zero in early April 2016 for the first time in history. The narrowing of the deficit in 2015 was driven by the cyclical factors, while the structural balance remained roughly unchanged, thus resulting in a neutral policy stance. The fiscal stance is expected to become slightly expansionary in 2016, providing further impetus to the recovery. However, six countries in the euro area remain subject to excessive deficit procedures, as progress towards meeting the thresholds of the Stability and Growth Pact is considered unsatisfactory.

34. The situation in Greece was a source of uncertainty early in the year, amid concerns regarding its exit from the euro area. As the country failed to implement the reforms required to access funding, currency controls and bank restrictions were introduced. An agreement was reached in late summer on a new programme of support which re-established access to funding and slowed down the rate of contraction, but was not sufficient to avoid further economic decline in 2015.

35. Given the central role of the banking system in channelling finance in the euro area, in particular for small and medium-sized enterprises, increasing credit flows plays a critical role in the recovery. This is different from the United States, where capital markets are more relevant for corporate financing. Monetary conditions have been accommodative and bank lending rates in the euro area, in particular in countries in the periphery, continued to trend down. Lending surveys have shown easing of lending conditions up to the first quarter of 2016. Financial fragmentation has been reduced, as differences across the economies of the area narrowed. However, high levels of private sector leverage and non-performing loans continue to constrain credit expansion in some economies. Banking fragilities persist, and there is still a need in some countries for a long-term response to tackle this issue.

36. As a response to existing deflationary trends, the European Central Bank continued to provide further monetary stimulus to secure a return of inflation to rates just below 2 per cent, in accordance with its stated target. The balance sheet of the European Central Bank contracted in 2012-2014, as banks repaid loans granted during the crisis, but this course was reversed in January 2015 as the central bank initiated large-scale asset purchases. Unconventional monetary policy measures have increased in importance. In March 2016, the asset purchase programme was extended further, and euro-denominated corporate bonds have been included among the securities to be purchased. New longer-term refinancing operations were introduced to encourage bank lending. In addition, the deposit rate moved further into negative territory, with a 10 basis point cut that left it at minus 0.4 per cent.

37. While further cuts in the deposit rate are seen as a possibility, there are also concerns regarding the potential adverse implications of negative rates for the stability of the financial system. Negative deposit rates are intended to prod banks to lend while encouraging further economic activity through the weakening of the exchange rate. However, negative rates also have a negative impact on banks' profitability, as lenders have been reluctant to pass the costs of negative rates to deposit holders. Increases in lending rates may follow as a way to preserve margins. This unintended effect goes against the aim of this policy.

38. Continued monetary policy stimulus and low oil prices will support the recovery further. However, there are limits to what monetary policy can achieve in a situation characterized by absence of price pressures, low investment demand and weak productivity growth. Monetary policy alone cannot address the problems of countries that need more support, as real interest rates are higher in those countries with higher unemployment rates. This is the result of comparatively lower levels of inflation. Structural policies, including active labour market policies, increased competition and removal of barriers to the internal market, are also necessary to promote productivity growth and encourage economic dynamism. However, in a context of low demand, their impact would be limited, so coordinated initiatives to increase demand may also be necessary.

39. The economic recovery in the euro area is facing a number of internal and external risks. The refugee crisis may lead to the imposition of border controls that would create barriers for the free flow of goods and fragment the Schengen space, thus imposing significant costs. Uncertainty continues to hold back investment. Slower global growth and increased volatility in financial markets, revisiting the substantial declines in asset prices seen at the beginning of 2016, would create a less auspicious environment for the ongoing recovery. Like other advanced economies, the euro area needs to address challenges that are undermining its long-term social cohesion and economic prosperity: rising inequality, low productivity growth and ageing.

B. Other advanced countries

40. Economic growth slowed in the United Kingdom from 2.9 per cent to 2.2 per cent in 2015, still much faster than the euro area but narrowing the previous distance. Domestic demand was the main driver of this expansion, with robust consumption and investment. The household sector saving ratio reached a 50-year low, at 4.4 per cent, amid declining unemployment, growing incomes and increased net financial wealth, which altogether support consumption. While rising debt levels do not point to increased vulnerability in the household sector as a whole, there are some groups that may be stretched. Despite strong domestic demand, inflation remained flat in 2015 as a result of lower oil prices, currency appreciation, moderate wage growth and a competitive retail sector. The weakening of the pound since late 2015 will create some inflationary pressure. Monetary authorities have left rates on hold and continued to point out that the necessary conditions for an increase were not yet present.

41. In contrast to the strength of domestic demand, net exports were a drag on growth. The current account deficit has been large by historical standards in recent years and it remained roughly unchanged in 2015 at around 5 per cent of GDP. The associated large external financial needs have become a focus of attention in the context of the referendum on European Union membership, which will take place on 23 June 2016.

42. If the result of the vote supports the exit from the European Union, this would open a period marked by significant uncertainties regarding trading and regulatory arrangements applicable to the relation between the United Kingdom and the European Union. Negotiations would take place on the terms under which the United Kingdom would trade with the European Union but also with the rest of the

world, as currently European Union rules apply in trade relations with third countries. United Kingdom authorities would also have to decide on the applicability of existing European Union rules under national legislation. Leaving aside the long-run economic consequences of the decision to leave, it is clear that this uncertainty would have immediate negative consequences that would spread beyond the United Kingdom. In the run-up to the referendum, increased market volatility and some slowdown in investment are likely to occur.

43. Sweden was one of the fastest growing economies in the European Union in 2015, with GDP increasing by 4.1 per cent. In the last three years, the expansion has been close to 8 per cent. Consumption, supported by rising incomes and increased employment, has been the main driver of this remarkable expansion. Refugee inflows, which have been large on a relative basis, have boosted government spending. Amid rapid growth, public finances continued to improve nevertheless. A housing boom has boosted residential investment and contributed further to economic dynamism. Despite the strength of demand and the impact of indirect tax increases, inflation has remained subdued owing to low oil prices and an appreciating currency. Monetary authorities continued to cut rates further into negative territory and expanded the bond buying programme in early 2016.

44. In Denmark, growth moderated in 2015, as the weakness of investment offset the relative buoyancy of consumption. Household debt as a percentage of disposable income is the largest among advanced countries and therefore consumption is particularly sensitive to the improvement of financial conditions. Monetary policy is attuned to the need to preserve the peg to the euro, with the deposit rate remaining firmly in negative territory, despite an increase in January 2016.

45. Outside the European Union, the Swiss economy showed significant resilience in the face of the appreciation of the Swiss franc, which followed the removal of the exchange rate floor in January 2015. Core inflation was strongly negative in 2015. These disinflationary dynamics are going to persist in 2016, given the large impact of the exchange rate in a small and very open economy. Negative interest rates have contributed to rapid growth in house prices, which has been tempered by the introduction of macroprudential measures to cool the housing market.

46. Norway's economy suffered from low oil prices and is drawing down resources from its sovereign wealth fund to offset the impact. A worsening outlook for the oil sector affected investment and consumer confidence but the depreciating exchange rate and a looser monetary policy facilitated adjustment and provided impetus to the non-oil export sector. With unemployment at its highest level in a decade, monetary authorities cut rates to 0.25 per cent in March 2016, without ruling out further reductions. As in a number of other advanced countries, low interest rates have fuelled rapid increases in housing prices.

V. Emerging economies

A. New European Union member States

47. Economic performance in this group of countries improved in 2015, with aggregate GDP growing by 3.5 per cent, as compared with 2.8 per cent in 2014. This was much faster than the expansion observed in the rest of the European Union

or the euro area, so convergence with income levels in older European Union members continued. However, the pattern of convergence after the 2008-2009 crisis is much slower than observed in the first years after European Union accession, reflecting the substantial deceleration of growth in relation to the pre-crisis period. While expansion rates of 5 to 6 per cent were typical in these countries before the crisis, the "new normal" is in the 2 to 3 per cent range. Large inflows of foreign direct investment have played an important role in boosting production capacity and integrating these countries into global supply chains. In countries where this process has been less intense, income convergence has also been slower.

48. Before the crisis, the new European Union member countries were running very large current account deficits, which were financed by bank lending and foreign direct investment. This was accompanied by rapid credit growth, rising house prices and exchange rate appreciating pressures. The post-crisis environment is markedly different. There has been a significant turnaround in external balances, with most countries now running surpluses.

49. The expansion of economic activity in 2015 was propelled by domestic demand, which was boosted by low interest rates and strong labour markets. Financing conditions have improved, with credit available more easily and on less restrictive terms. However, the stock of private-sector bank loans declined in some countries, in particular Hungary and Romania. While non-performing loans accounted for a smaller share of all loans, they remained a problem. European Union-funded investment added further impetus to the expansion. Low energy prices contributed to subdued inflation and strengthened external balances.

50. Unemployment has been on a declining trend but some negative trends are also visible in the labour market. In the presence of significant outward migration and adverse demographic trends, some countries are facing labour shortages in particular regions and sectors. This problem is compounded by insufficient internal mobility and the limitations of educational systems.

51. Growth is expected to slow down somewhat in 2016. Policies will remain supportive, with persistent low interest rates and a neutral or, in the case of Poland, expansionary fiscal stance. However, the consumer boom will cool off and investment will weaken, given lower access to European Union funds owing to the disbursement cycle. These transfers were equivalent to 2 to 3 per cent of GDP in most countries, exceeding 3 per cent in Hungary. Bulgaria, the Czech Republic and Hungary will be the countries most affected by lower access to European Union funds. Overall, the growth differential with the rest of the European Union is likely to narrow.

52. The external outlook — regarding the European Union and beyond — remains the main threat for future economic performance. The new member countries' economies have a high degree of openness, so any slowdown in partner countries, in the European Union in particular, would affect their economic prospects. While the exposure to China is relatively limited, the importance of mutual linkages increases once the impact of participation in global supply chains is taken into account.

53. In Poland, the largest economy among this group of countries, strong domestic demand and low interest rates resulted in a small acceleration of growth to 3.6 per cent. The rapid increase of exports led to a sharp compression of the current account deficit, which almost disappeared. A similar performance is expected in 2016,

against a background of significant fiscal easing. Financial conditions for private sector investment have improved but public investment will lose momentum, given the pattern of access to European Union funds. The sustained expansion is not translating into inflationary pressures, with prices declining by 0.5 per cent in 2015. Deflation will continue through most of 2016, as the pace of reflation is going to be limited by the renewed decline in fuel prices in a context in which strong retail competition has contributed to keeping prices low. The policy rate was cut to 1.5 per cent in the first quarter of 2015 and has remained unchanged since then. A weakening currency and projected fiscal expansion are likely to limit further easing.

54. In the Czech Republic, growth accelerated sharply in 2015, more than doubling to reach 4.3 per cent on the back of robust consumption and, in particular, investment, which was boosted by the desire to tap into European Union funds before the end of the current financial cycle. While investment will come down, consumption is expected to remain strong, driven by a dynamic labour market and improved credit conditions. Despite the acceleration of growth, there have been few price pressures, with inflation ending the year at 0.1 per cent. The Czech National Bank has signalled its intention to continue an expansionary policy stance by delaying the abandonment of the exchange rate floor. This is a response to loosening by the European Central Bank and continued low inflation. Negative deposit rates may be considered to discourage capital inflows that could lead to excessive appreciation. By contrast, fiscal plans point towards further consolidation, with public debt on a declining path since 2013.

55. Hungary is enjoying a recovery of demand from previously depressed levels, posting a strong performance in 2015, with GDP increasing by 2.9 per cent. However, this is below the rate observed in 2014 and the expansion registered in neighbouring countries. After years of austerity, fiscal policy is becoming expansionary. Inflation ended the year at 0.9 per cent and further declines in oil prices imply that price increases will remain well below the 3 per cent target in 2016, which suggests further easing of monetary conditions. However, growth is likely to decline, as the strong contribution of European Union funds to investment fades away after record inflows in 2015 of around 6 per cent of GDP. The typical cyclicality in the disbursements of these funds has been particularly marked in Hungary. Consumer demand, however, will remain strong amid an improving labour market, the favourable impact of the redenomination of households' foreign exchange loans and low inflation.

56. Economic activity picked up in Romania in 2015, with GDP increasing by 3.8 per cent. Domestic demand has been the main driver of expansion, with household consumption in particular being boosted by wage increases and fast credit growth. Investment also picked up, but a relatively low rate of absorption of European Union funds prevented faster increases. The impact of the recovery on employment has been muted, however, in a context of rapid wage gains. Further acceleration of economic growth is expected in 2016, supported by a looser fiscal policy envisaging tax cuts and minimum wage increases.

57. In Bulgaria, economic expansion accelerated sharply, with GDP growing by 3 per cent, double the rate observed in 2014. This was mainly driven by net exports and strong public investment. The national currency is pegged to the euro, so exports have also benefited from the lagged effects of depreciation. These are particularly relevant for Bulgaria, as around 40 of its exports have destination

countries outside the euro area. By contrast, consumption was relatively subdued in a context of low wage growth. Public finances improved markedly, as the 2014 outturn was negatively influenced by the support provided to the financial sector. The expansion is expected to moderate in 2016, as public investment will suffer from lower implementation of projects financed by the European Union.

58. Croatia, the last country to join the European Union in 2013, returned to growth in 2015 after six years of recession. The recovery was due to both domestic and external demand, as tax cuts encouraged consumption and European Union funding boosted investment. Exports performed strongly, resulting in a current account surplus of more than 4 per cent of GDP. They are expected to continue to make a strong contribution to growth in 2016 as well, driven by Croatia's increasingly closer relations with other European Union members. Robust growth facilitated the reduction of the deficit, but the fiscal gap remains large and public debt continued to climb.

B. South-Eastern Europe

59. Economic activity picked up in the Western Balkans region in 2015, following the damaging impact of the floods in Serbia and Bosnia and Herzegovina. Improved performance in the European Union and lower energy prices provided a favourable external environment. The expansion was modest in Serbia, the largest economy, with GDP increasing by 0.8 per cent. It is expected to accelerate in 2016, supported by stronger investment and continued good export performance. Growth in other countries in this region has been much faster. Investment has been a major driver of the expansion, supported by accelerating credit and, in a number of countries, large public investment projects. By contrast, consumption remained relatively subdued amid low inflation. The economic recovery supported job creation, but it was insufficient to address the large structural unemployment that is characteristic of the region. High unemployment is accompanied by low activity rates, which limits growth potential.

60. While the levels of public debt are high, there has been significant progress in reducing fiscal imbalances. In Serbia, the large budget deficit, which represented a major policy concern, shrank considerably thanks to better revenue collection and a number of one-off measures. Despite the acceleration of exports and remittances, driven by the recovery in the European Union, large current account deficits remained throughout the region. Albania, a net energy exporter, was the only country not to benefit from low oil prices. While strong foreign direct investment has contributed to financing these imbalances, foreign debt has also increased in the region in recent years.

61. The reliance on external financing makes these countries vulnerable to a tightening of global financing conditions. Non-performing loans are a source of financial fragility that constrains future credit growth. Economic developments in the European Union, the main commercial partner and source of investments and remittances, will exert a major influence on economic prospects.

62. Economic growth picked up in Turkey in 2015, reaching 4 per cent, up from 3 per cent. The acceleration was driven by increased consumption and the recovery of investment. The pace of expansion is likely to slow down in 2016, partly driven by the impact of geopolitical tensions and Russian sanctions on tourism revenues.

However, strong government spending and increases in the minimum wage in early 2016 will have an expansionary effect. Inflation remained high, as the depreciation of the exchange rate limited the positive impact of falling oil prices. The marked slowdown in credit growth since 2012 has continued, as domestic financial conditions have tightened in a more adverse environment for external financing. However, the credit-to-GDP ratio has doubled in the last five years, in what has been a remarkable and sustained credit boom. The current account deficit has halved in the last three years, falling to 4.4 per cent of GDP, as the country benefited from lower oil prices and reduced gold imports. This adjustment has taken place in the context of low investment and saving rates in comparison with peer countries, which limits potential growth.

C. Commonwealth of Independent States

63. Economic performance in the Commonwealth of Independent States deteriorated sharply in 2015 under the impact of falling commodity prices and geopolitical tensions. Aggregate GDP shrank by 3 per cent after having increased by a mere 0.9 per cent in 2014. While some small economies are net energy importers and therefore could benefit from low oil prices, the positive effect of a lower import bill in these countries has been offset by the transmission of shocks from the Russian Federation. Large depreciations, including those that followed the abandonment of currency pegs in some countries, have boosted inflation. In the presence of significant financial dollarization in many countries in this region, devaluations are a source of banking fragility owing to currency mismatches and the negative impact on debtors' creditworthiness.

64. In 2016, aggregate output is expected to continue to shrink, albeit at a more reduced pace. Low oil prices will force adjustments in energy exporting countries, which will have a depressing effect throughout the region. The persistence of low oil prices and its negative implications are a powerful reminder of the need for economic diversification in order to increase resilience. While energy producers have put fiscal frameworks in place to manage hydrocarbon revenues, much progress is required to facilitate changes in the productive structure that reduces the existing dependence on commodities. Investment is the key channel through which diversification could take place, but it has been shrinking sharply in many countries in the region.

65. The Russian Federation experienced multiple shocks in 2015, including the collapse of the oil price, the depreciation of the rouble and trade disruptions resulting from sanctions and counter-sanctions. Output fell by 3.6 per cent amid plummeting consumption and investment. The continued weakness of the oil price, despite some pickup early in 2016, and the associated fiscal and monetary policy responses will postpone the recovery. As a result, the economy is likely to contract for a second consecutive year. The weakness of consumption will continue, given labour market dynamics and wage freezes in the public sector.

66. The depreciation of the rouble has facilitated the adjustment to lower oil prices, leading to a sharp contraction of imports. Bans on certain imports from Western countries, Ukraine and, as of December 2015, Turkey, also contributed to the decline in imports. The contraction of imports played an important role in limiting the fall of GDP in the context of a large decline of domestic demand.

Import substitution has benefited some sectors, in particular agriculture, food processing and defence goods. However, shrinking investment has prevented the potential for localization from being more fully exploited.

67. The current account surplus increased from 3.1 per cent of GDP in 2014 to 5.3 per cent in 2015, largely as a result of the compression of imports. By contrast, fiscal adjustment was less successful than external rebalancing. Hydrocarbon revenues dropped by around a fifth, or 2.5 per cent of GDP, while expenditures remained flat as a percentage of GDP. Monetary authorities cut rates rapidly in early 2015, reversing the sharp hikes of late 2014, as inflation declined and the exchange rate stabilized. However, renewed rouble weakness associated with further oil price declines resulted in a more cautious attitude, with rates being on hold since the summer. Inflation declined through the year, ending at 12.9 per cent and falling further to 7.3 per cent in March 2016. While inflation expectations remain elevated, base effects and depressed domestic demand suggest further declines.

68. Fiscal adjustment will be a key challenge for the Russian Federation in 2016, as oil prices are likely to be lower than initially envisaged. The use of the Reserve Fund, where part of past hydrocarbon revenues has been accumulated, provides some flexibility but cannot avoid the need for spending cuts to prevent the depletion of resources. The increased current account surplus fully accommodated net private capital outflows in 2015, which were only around one third of the record levels observed in 2014. Banks and corporates deleveraged significantly and, as a result, debt redemption payments in 2016 will be significantly lower. The sanctions have made access to international capital markets more difficult, but the increased reliance on domestic resources means that the Russian Federation is relatively better placed than other emerging economies to cope with a more difficult environment for raising finance. While external debt declined in nominal terms, the depreciation of the rouble drove an increase in its value as a percentage of GDP of around 10 percentage points over the previous year.

69. In Ukraine, output contracted by almost 10 per cent in 2015, with a cumulative decline of around 20 per cent from 2013 to 2015. Fiscal austerity contributed to plummeting domestic demand, with consumption in particular falling by around one fifth in 2015. Modest growth is likely to emerge in 2016, as there were already signs of some stabilization late in 2015. However, a tight budget and the uncertainty linked to the geopolitical situation will dampen demand. Consumption will remain subdued as high inflation erodes real incomes, while export growth will be limited at best, given trade disruptions. There has, however been marked progress in reducing inflation, which came down to 20.9 per cent in March 2016 from a peak 60.9 per cent in April 2015. This has allowed some monetary easing, which is likely to continue.

70. The turnaround in Ukraine's external balance has been remarkable. The current account deficit shrank from 9 per cent of GDP in 2013 to less than 0.5 per cent in 2015. Imports fell as a result of weak domestic demand and currency depreciation, but also owing to the imposition of special import duties, which are being lifted in 2016. However, the export potential of the country has been severely affected by trade restrictions with the Russian Federation and the conflict in the eastern part of the country.

71. Ukraine entered the Deep and Comprehensive Free Trade Area (DCFTA) with the European Union in January 2016. Most Ukrainian exports already had free

access to the European Union market since April 2014, with the notable exception of agricultural products. However, exports to the European Union fell sharply in 2015, partly reflecting lower commodity prices. The Free Trade Area envisages the gradual adoption by Ukraine of European Union standards and regulations in many areas. The absence of accord on how to address the potential impact of this agreement on the Russian Federation led to a number of retaliatory measures, including the suspension of the free trade agreement between the two countries, an embargo on food imports and transit restrictions.

72. Belarus's economy shrank by almost 4 per cent in 2015 as a result of powerful contractionary domestic and external forces. These included the recessions in the Russian Federation and Ukraine, falling real wages amid declining but still high inflation and restrictive policies. Fiscal constraints became tighter owing to the ongoing output decline but also to the loss of oil duty revenue resulting from lower prices for oil products. The current account deficit shrank but external financing needs are still large. The contraction of economic activity is likely to continue in 2016, as severe external constraints will prevent the adoption of more expansionary policies.

73. Like other energy-exporting countries in the region, Kazakhstan suffered from a deterioration in its terms of trade owing to the fall in oil prices. The contractionary effect was compounded by the recession in the Russian Federation and the slowdown in China, which is becoming an increasingly important commercial partner. Growth decelerated sharply in 2015, with GDP increasing by 1.2 per cent, down from 4.1 per cent in 2014. Persistently low oil prices and tighter policies create strong headwinds for economic activity in 2016.

74. Falling oil prices eroded public finances, as hydrocarbon revenues represented around half of the total. Kazakhstan dipped into its National Oil Fund to avoid a harsher adjustment, but fiscal consolidation and efficiency gains in spending are being sought to prevent a rapid decline of the accumulated resources. The sharp deterioration in the terms of trade resulted in a swing of more than five percentage points of GDP in the current account in 2015, which moved into a deficit close to 3 per cent of GDP. Following the abandonment of the currency peg in August 2015, the tenge lost around half its value in relation to the dollar in the course of six months. This depreciation boosted inflation and prompted the National Bank of Kazakhstan to tighten monetary policy.

75. Economic performance in other countries of the Commonwealth of Independent States, including energy producers, was varied. Azerbaijan suffered from the declining low oil prices and had to adjust to the new adverse environment by slashing public spending on infrastructure and letting the currency depreciate abruptly. A sharp slowdown in growth in 2015 is likely to be followed by an outright contraction in 2016. In non-oil-exporting countries, the benefits of lower oil prices have been offset by the impact of the recession in the Russian Federation in terms of lower exports, investment and, in particular, remittances. Migrant transfers are very large for Kyrgyzstan and Tajikistan and the existing social protection systems are ill-prepared to cope with the large drops observed. China has become an increasingly important partner of Central Asian countries, and its worsened economic outlook is also a risk factor for those countries.

76. Kyrgyzstan joined the Eurasian Economic Union in August 2015, becoming the fifth member of the group, which includes also Armenia, Belarus, Kazakhstan and the Russian Federation. Despite the potential of this association to promote mutual trade and contribute to economic dynamism in the region, trade among its members declined in the first year of its existence in the context of a general drop in economic activity, although the decline was lower than that observed in trade with the rest of the world. With the accession of Kazakhstan to the World Trade Organization in July 2015, Belarus is now the only member of the Eurasian Economic Union that remains outside this global organization.

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Overview of economic and social conditions in Africa, 2016

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith an overview report on economic and social conditions in Africa for 2016.

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Overview of economic and social conditions in Africa, 2016

[Original: Arabic, English and French]

I. Introduction

1. Africa's economic growth declined moderately following the slight contraction in growth in the global economy, which was mainly due to subdued growth in emerging markets and developing economies, while a chequered recovery continued in developed economies. Looking forward, Africa's real GDP growth is expected to increase to 4.3 per cent in 2016 and 4.4 per cent in 2017.

2. Growth continues to be driven by strong domestic demand and investment (particularly in infrastructure). The improving business environment, lower costs of doing business and better macroeconomic management continue to enhance investment. The buoyant services sector and a focus on non-oil sectors by oil-exporting economies to mitigate the continued decline in oil prices will contribute to the positive medium-term prospects. In addition, the increasing trade and investment ties within Africa, and between Africa and emerging economies, as well as the recovery of traditional export markets, particularly in the Eurozone, will positively contribute to the medium-term prospects.

3. All the African subregions and economic groupings experienced current account deficits in 2015 that were driven to some extent by declining commodity prices, as oil-exporting countries recorded the first current account deficit since 2009 in 2014. On the other hand, low oil prices led to the narrowing of the deficit in oil-importing countries. Most African countries exercised tight monetary policy as global headwinds weighed on the region, mainly to curb rising inflation together with high fiscal and current account deficits. Inflation rates increased mainly as a consequence of weaker domestic currencies owing to declining commodity prices and rising food prices on the continent.

4. Africa's medium-term prospects remain positive, despite the downside risks such as the current dry spell over the East and Southern parts of the region, which might significantly affect agricultural production as most of the economies are based on agriculture. The weak global economy, monetary tightening in developed economies and security and political instability concerns in some countries still remain a challenge.

II. Developments in the global economy and implications for Africa

5. Global growth declined moderately from 2.6 per cent in 2014 to 2.4 per cent in 2015, reflecting subdued growth in investment and household final consumption. The economic slowdown and rebalancing of economic activity in China away from investment and manufacturing towards consumption and services, lower prices for energy and other commodities (affecting economic activity in countries such as Brazil and the Russian Federation, as well as in other commodity-exporting countries) and gradual tightening in monetary policy in the United States are some of the key factors that have weighed negatively on global growth.

6. GDP growth in developed economies edged up moderately from 1.7 per cent in 2014 to 1.9 per cent in 2015 and is expected to rise to 2.2 per cent in 2016, mainly driven by increased growth in the United States and the euro area. In the United States, growth remained around the 2014 levels of 2.4 per cent, and is expected to increase moderately to 2.6 per cent in 2016, driven by a combination of factors such as increased private consumption — which benefited from steady job creation in every sector, income growth, lower oil prices and improved consumer confidence — and the decreased unemployment rate.[1] In Japan, growth reached 0.5 per cent in 2015 compared to -0.5 per cent in 2014, and projected to reach 1.3 per cent in 2016. In the euro area, growth shifted from 1.4 per cent in 2014 to 1.9 per cent in 2015, underpinned by improved confidence and a recovery in the banking sector, but also by increased consumption supported by lower oil prices, higher net exports and the tapering off of fiscal consolidation. Despite the crisis of illegal migration, growth is projected to continue on its positive path to reach 2.0 per cent in 2016.

7. In emerging and developing economies, GDP growth declined from 4.3 per cent in 2014 to 3.8 per cent in 2015, underpinned by weaker export demand, lower commodity prices and lower capital inflows and investments. In some cases military conflicts, natural disasters and adverse weather effects on agricultural output exerted downward pressure on growth over the period. However, stronger demand from developed countries and expected stabilization of commodity prices are expected to edge up growth to 4.3 per cent and 4.8 per cent in 2016 and 2017, respectively. The slowdown in the Chinese economy and the geopolitical tensions in the Russian Federation, coupled with declining confidence, and the lower oil price point to some further slowdown in the short and medium term of GDP growth in emerging and developing economies. At the regional level, economies in East and South Asia grew by 5.7 per cent in 2015 and are expected to increase marginally to 5.8 per cent in 2016. In Latin America and the Caribbean, GDP growth fell from 1.0 per cent in 2014 to -0.5 per cent in 2015, slowing down for the third consecutive year. However, the outlook is positive, and growth is projected to recover to around 0.7 per cent in 2016.

8. Global unemployment declined to 7.5 per cent in 2015 from 7.8 per cent in 2014 owing to growth recovery in the developed economies, although they will continue to face a higher rate of unemployment. In Africa and the Middle East, the unemployment rate was estimated to be more than 15 per cent in 2015 but projected to further increase. Countries in Africa and the Middle East continue to suffer from high unemployment rates, in some cases up to 30 per cent of the labour force.[2] The trends in the youth employment-to-population ratio declined for all regions except Africa (excluding North Africa), where it increased from 46.9 per cent in 2000 to 48.0 per cent in 2014.[3]

9. Global inflation declined from 3.1 per cent in 2014 to 2.6 per cent in 2015, reflecting the decline in commodity prices, especially oil, and weakened demand in a number of emerging and advanced economies. In developed economies, inflation

[1] International Monetary Fund, *World Economic Outlook: Uneven Growth — Short- and Long-Term Factors* (Washington, April 2015).

[2] International Labour Organization, *World employment and social outlook: Trends 2015* (2015).

[3] International Labour Organization, *Global Employment Trends for Youth 2015: Scaling up investments in decent jobs for youth* (Geneva, International Labour Office, 2015).

will remain below 2 per cent and is projected to reach 1.2 per cent in 2016 compared to 0.3 per cent in 2015. Low inflation in developed countries is partly due to declining demand and accommodative monetary policy (especially in Japan and the euro area) to support economic activity and bring inflation back to the target rates. In emerging and developing economies, depreciation of domestic currencies as a result of low commodity prices, coupled with the strong United States dollar, and high food prices that account for a large share in the consumer price index, led to an increase in inflation from 6.7 per cent to 7.7 per cent in 2015. This has been relatively more pronounced in oil-exporting countries in Africa.

10. Growth in world trade remained subdued in 2015 at 2.6 per cent, the lowest rate since the global financial crisis, mainly owing to weak aggregate demand in emerging and developed economies, especially China and those in the euro area, the appreciation of the United States dollar against other currencies and rising geopolitical tensions in Iraq and the Syrian Arab Republic, and between Ukraine and the Russian Federation. These developments have had significant effects on trade in developing countries, including those in Africa. However, in the short term, trade growth is projected to accelerate to 4.0 per cent in 2016, thanks to strengthening demand from developed countries, which is expected to lift exports from developing countries.

11. The global current account imbalances remained quite stable in 2015 compared to 2014 and are projected to keep the same trend in the short term despite the weakening commodity prices. Growth in global net foreign direct investment (FDI) increased slightly in 2015, underpinned by the increase in net FDI in low-income developing countries, where it peaked at 5.3 per cent compared to 4.8 per cent in 2014 (World Bank, 2015).[4]

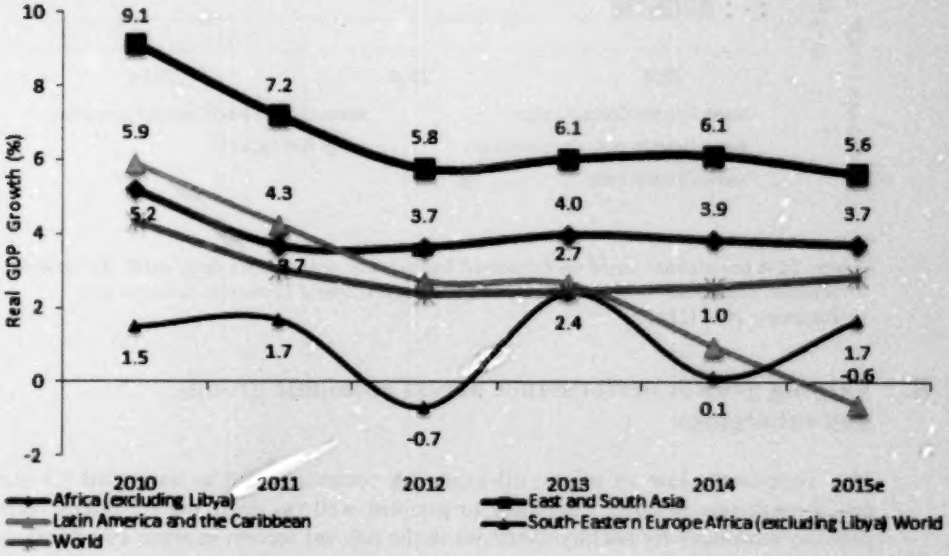
12. The global outlook in the short term is slightly positive with growth projected at 2.9 per cent in 2016 reflecting a further increase in emerging and developing economies, in particular in Brazil, China and the Russian Federation, as well as in Middle Eastern countries and other Latin American countries. Nevertheless, the macroeconomic uncertainties that have persisted since the global financial crisis and the volatility of commodity prices will continue shaping the medium-term outlook. Against this backdrop of falling commodity prices, global growth patterns, declining trade flows, capital flows and diverging monetary policies, exchange rate volatilities have become more pronounced. The continued decline in oil prices, however, may generate a positive outlook for the African continent because of the number of oil importers, while oil exporters may see a deterioration of their current account balances and depreciation of their exchange rates. The overall impact on Africa will strongly depend on the recovery in China and the euro area, which are Africa's main trade partners. The political tension in Syria and some other parts of the Middle East, coupled with the issue of illegal migration facing the euro area, will also create serious concerns, as it will directly affect the demand side in Africa's trade partners. Tightening monetary policy in the United States resulting in a muted increase in United States interest rates will also enhance the movement of capital outflows from developing and emerging economies.

[4] World Bank, *Global Monitoring Report 2014/2015: Ending Poverty and Sharing Prosperity* (Washington, 2015).

III. Africa's economic performance and prospects in 2015

13. Africa's growth rate is estimated to decline slightly from 3.9 per cent in 2014 to 3.7 per cent in 2015 owing to the global economic slowdown (see figure 1). Yet Africa's growth is the second fastest after East and South Asia. Growth in Africa continues to be driven by domestic demand (see figure 2). Growth in private consumption is influenced by increased consumer confidence and an expanding middle class on the continent, while investment is driven mainly by an improved business environment and lower costs of doing business. Continued government spending on infrastructure projects, in particular, has also been positively contributing to growth. The external balance, however, had a negative impact on growth in 2015, as a result of weak and volatile commodity prices.

Figure 1
Economic growth in Africa and emerging and developing countries, 2010-2015



Note: e = estimate.

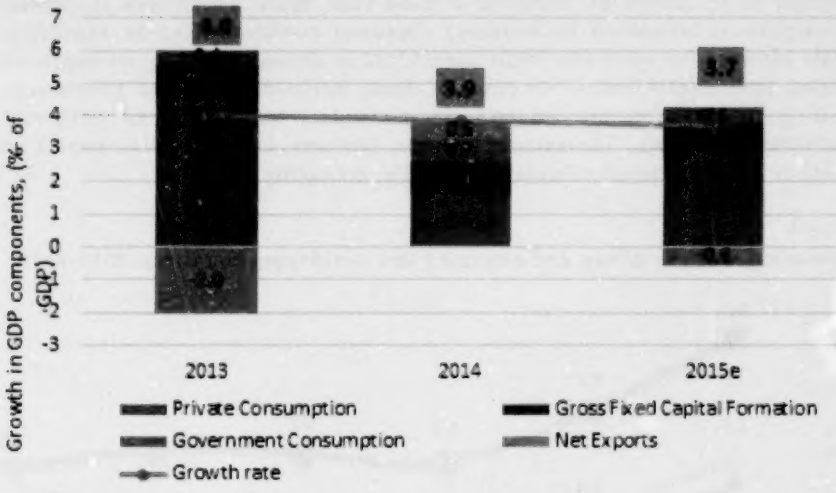
Source: ECA calculations based on United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015) and Economist Intelligence Unit country data, 2015.

A. Private consumption continues to be the main driver of Africa's growth

14. Relative to GDP, private consumption's growth rate increased from1.6 per cent in 2014 to 2.7 per cent in 2015, representing 73 per cent of total GDP growth in the later year (see figure 2). Despite the increase in infrastructure development on the continent, gross fixed capital formation grew at only 1.0 per cent relative to GDP, accounting for 27 per cent of total GDP growth in 2015 (the same as in 2014). This was mainly due to the reduction in capital inflows as a result of the slowdown in the global economy, especially among Africa's development partners in the euro area

and some emerging economies such as Brazil, China and the Russian Federation. Net exports continued to weigh negatively on growth in 2015.

Figure 2
Africa's GDP growth and associated components, 2013-2015

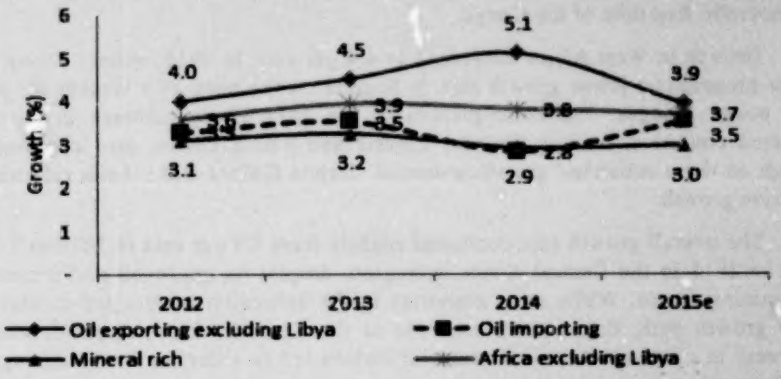


Note: e = estimate.
Source: ECA calculations based on Economist Intelligence Unit country data, 2015, and United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

B. Varying growth performance across economic groups and subregions

15. Despite the low oil prices, oil-exporting countries, with an estimated 3.9 per cent growth rate in 2015, continued to perform well (as declining oil prices were partially cushioned by healthy dynamics in the non-oil sectors in some countries) as compared to both oil-importing and mineral-rich countries, with an average growth of 3.5 per cent and 3.0 per cent respectively (see figure 3). Growth in these two latter group of countries was mainly driven by private consumption, increasing at 2.5 and 3.2 per cent relative to total GDP, respectively (see figure 4).

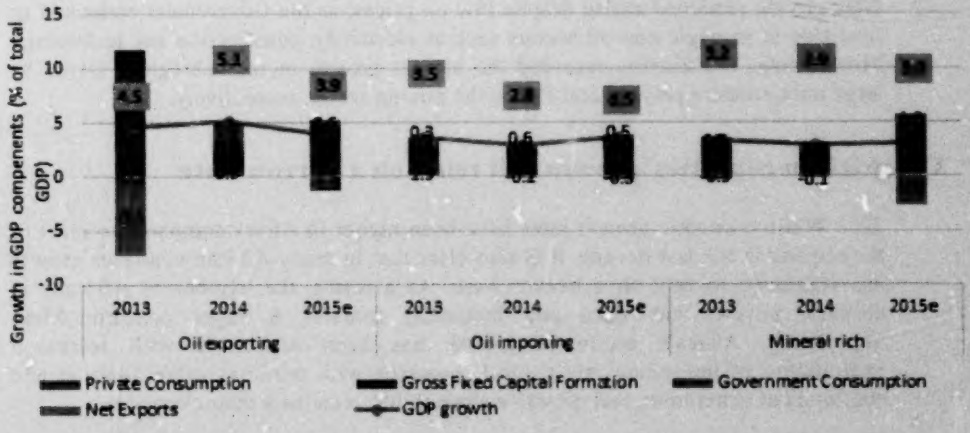
Figure 3
Africa's GDP growth performance by economic group, 2012-2015



Note: e = estimate.
Source: ECA calculations based on United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

16. Private consumption continued to be the main GDP growth driver across subregions in 2015, despite the decline in its share to growth in East and Central Africa, mainly due to the global economic slowdown that has led to a reduction in investment flows to these subregions. Compared to GDP, private consumption increased significantly in North, Southern and West Africa, growing at 2.2 per cent, 2.1 per cent and 3.4 per cent, respectively, in 2015. Meanwhile, gross capital formation also increased significantly in the East and North Africa subregions, growing at 1.8 per cent and 1.6 per cent relative to GDP, respectively, mainly as a result of increased investments in infrastructure projects in both subregions.

Figure 4
Africa's GDP growth and its components by economic group, 2013-2015e



Note: e = estimate.
Source: ECA calculations based on Economist Intelligence Unit country data, 2015.

17. At the subregional level, East Africa maintained the highest growth rate in the region at 6.2 per cent in 2015, despite experiencing a growth decline relative to 2014 levels, mainly as a consequence of lower growth in Ethiopia and the Democratic Republic of the Congo.

18. Growth in West Africa decreased to 4.4 per cent in 2015, mainly driven by a more pronounced lower growth rate in Nigeria on the back of a weaker oil sector and power outages. The consequences of the 2014 Ebola outbreak in the most affected countries, namely Guinea, Liberia and Sierra Leone, also continued to weigh on these countries' growth potential, despite Guinea and Liberia returning to positive growth.

19. The overall growth rate decreased slightly from 3.5 per cent in 2014 to 3.4 per cent in 2015 in the Central Africa subregion, despite its improved performance in the mining sector. While most countries in the subregion maintained a relatively high growth path, the security concerns in the Central African Republic and the decrease in oil production in Equatorial Guinea led to a decline in the subregion's GDP growth rate.

20. Growth in North Africa (excluding Libya) accelerated from 2.8 per cent to 3.6 per cent over the 2014-2015 period. The positive developments have been helped by the improved political and economic stability in the subregion, and the subsequent increase in business confidence, especially in Egypt and Tunisia. A significant inflow of external aid into Egypt has enhanced public expenditure and boosted investment in large infrastructure projects, such as the expansion of the Suez Canal. The gradual recovery of export markets and improved security should support growth, especially through tourism. Political challenges in Libya continue to have a negative impact on both political and economic governance, as well as economic performance in the subregion.

21. Southern Africa's growth increased marginally from 2.4 per cent in 2014 to 2.5 per cent in 2015. The improvement in growth performance of the subregion was heavily influenced by the relatively lower growth in its biggest economy, South Africa. Weak export demand and low prices for its key commodity exports, as well as electricity shortages, contributed to the country's subdued performance. In Angola, GDP growth remained strong despite low oil prices, as the Government embarked on investing in strategic non-oil sectors such as electricity, construction and technology. Mozambique and Zambia recorded the highest growth in the subregion, driven by large infrastructure projects and FDI in the mining sector, respectively.

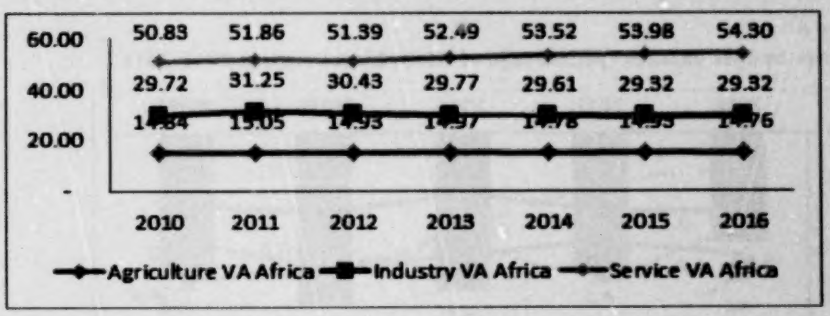
C. African countries' growth still relies on a narrow base

22. While economic growth rates have been higher in Africa compared to most of the regions in the last decade, it is also clear that in many African countries growth has continued to rely on a narrow base. As a result, the number of Africans in absolute poverty has risen and inequality remains a major concern. More importantly, Africa's economic growth has been associated with increased exploitation of non-renewable natural resources with minimal value addition and employment generation, and growth sustainability remains a major concern.

23. African economies are mainly dominated by the services sector followed by the industrial sector, with a marginal contribution from the agricultural sector

(see figure 5). However, it has been widely recognized that industrialization is critical for Africa's structural transformation and efforts to create jobs, foster value addition and increase income.

Figure 5
Sectoral share of GDP value added (VA) in Africa (percentage), 2011-2016



Source: ECA calculations based on Economist Intelligence Unit country data, 2015.

D. The impact of low oil prices on the growth of African economies is mixed

24. Crude oil prices declined at a monthly average of 4.1 per cent over the period from June 2014 to October 2015. Robust supplies and lower demand due to the global economic slowdown have generally explained the decline in commodity prices across the board.[1]

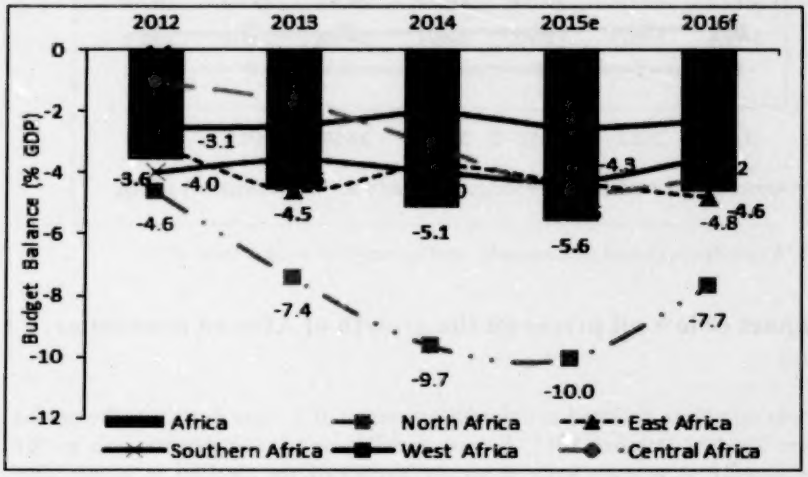
25. The Economic Commission for Africa's (ECA) analysis using monthly data from January 2000 to October 2015 reveals that oil prices have had a significant positive impact in oil-importing and mineral-rich countries, but a negative impact on oil-exporting countries. Thus, the overall effect of low oil prices on Africa's growth appears to be marginal. This marginal impact of the oil price decline emphasizes the significance of the continued diversification initiatives being undertaken by African countries, especially into non-oil sectors, and also the effect of improved macroeconomic management and the associated fiscal policies.

E. Low commodity prices and large investment projects underpin the growing fiscal deficits

26. Africa's fiscal deficit increased from 5.1 per cent of GDP in 2014 to 5.6 per cent of GDP in 2015 (see figure 6). The continued decline of oil prices and volatile commodity prices reduced fiscal revenues in many African countries, whereas high spending on infrastructure, fiscal loosening and higher spending in the lead-up to elections in a number of countries contributed to increased expenditure over the period. The fiscal deficit is expected to narrow in 2016 to 4.6 per cent of GDP as commodity prices and growth in emerging and developed economies are expected to pick up.

27. The fiscal deficit was the largest in North Africa, widening from 9.7 per cent of GDP in 2014 to 10.0 per cent of GDP in 2015. Over the period 2014-2015, the fiscal deficit increased in West Africa (from 2.0 per cent to 2.5 per cent), in East Africa (from 3.8 to 4.6 per cent) and in Southern Africa (from 4.0 per cent to 4.3 per cent). The deterioration of the fiscal balance was greatest in Central Africa, where the deficit widened from 3.1 per cent in 2014 to 4.6 per cent of GDP in 2015.

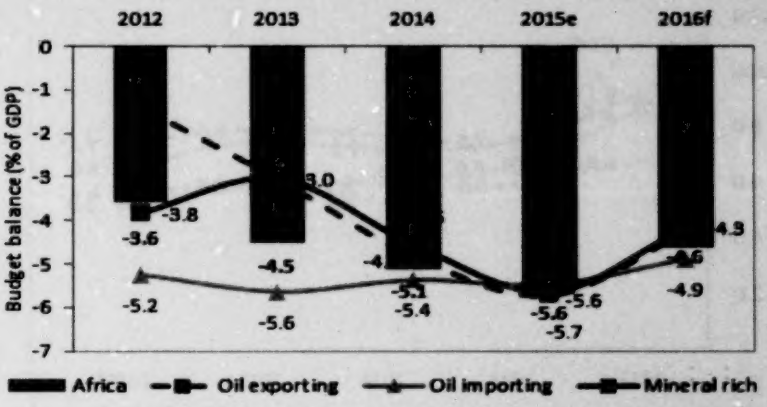
Figure 6
Average budget balance (percentage of GDP) by subregion, 2012-2016



Note: e = estimates; f = forecasts.
Source: ECA calculations based on Economist Intelligence Unit country data, 2015.

28. The fiscal deficits of oil-rich countries reached their highest levels since 2012 at 5.7 per cent, largely driven by the low oil price (see figure 7). Fiscal balances are projected to improve to 4.3 per cent of GDP in 2016 as commodity prices are envisaged to recover and as some oil exporters remove subsidies to alleviate pressure on their national budgets. However, with oil prices projected to remain below their recent peaks, fiscal revenues are not expected to return to earlier levels in oil-exporting countries.

Figure 7
Average budget balance (percentage of GDP) by economic groups, 2012-2016

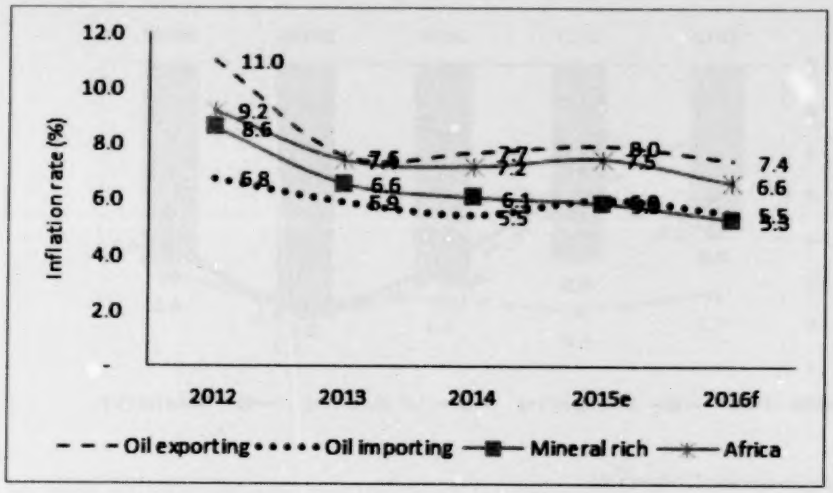


Note: e = estimates; f = forecasts.
Source: ECA calculations based on Economist Intelligence Unit country data, 2015.

F. Tight monetary policy amid falling commodity prices and declining revenues

29. African countries exercised tight monetary policy as global headwinds weighed on the region. As has been the case with most developing countries, the inflation rate rose from 7.2 per cent in 2014 to 7.5 per cent in 2015 (see figure 8). The strong United States dollar and high food prices exerted inflationary pressures in the region, despite weak global growth and low commodity prices partially offsetting the rise in inflation. Currency devaluations, especially in the oil-rich countries, amid falling oil prices and declining revenues and exports also exacerbated the rise in inflation. These inflationary pressures, together with high fiscal and current account deficits, have led to the tightening of monetary conditions, including the hiking of monetary policy rates in countries such as Angola, Ghana, Kenya, Malawi, South Africa, Uganda and others to curb inflation. However, a moderating trend is expected for 2016 and 2017 in view of lower food and energy prices, improved security situations and diminishing impacts from subsidy cuts in 2014.

Figure 8
Inflation by economic group, 2012-2016



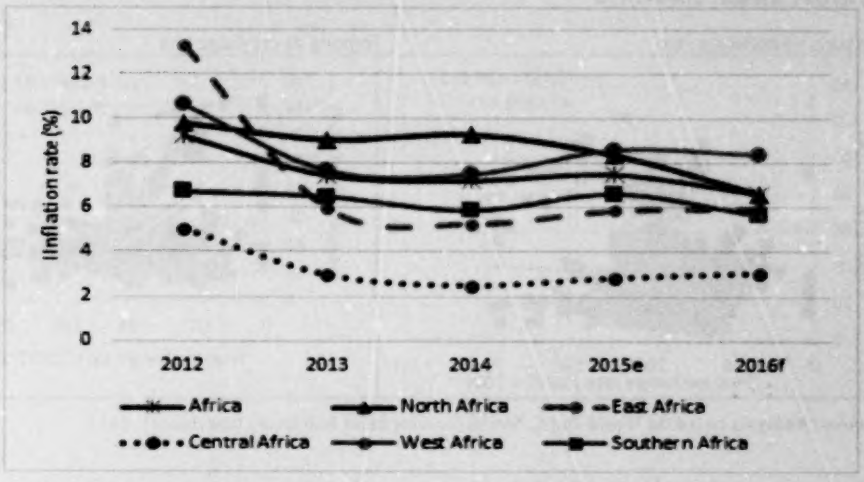
Source: ECA calculations based on United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

30. Inflation increased in all the subregions except North Africa (excluding Libya), where the inflation rate dropped from 9.3 per cent in 2014 to 8.4 per cent in 2015 (see figure 9). The decline was driven by the fall of inflation in the Sudan from 37.7 per cent in 2014 to 22 per cent in 2015, while inflation increased or remained stable in all other countries in the subregion. The drop in the Sudan was driven by the decline in international food prices and measures implemented by the central bank to contain inflation.

31. In East Africa, inflation increased from 5.3 per cent in 2014 to 5.9 per cent in 2015. In Southern Africa, it was recorded at 6.6 per cent in 2015 compared to 5.9 per cent in 2014. In Central Africa, it increased moderately from 2.5 per cent in 2014 to 2.8 per cent in 2015, mainly due to the decline in oil prices and global demand.

32. The depreciation of the euro against the dollar caused the depreciation of the CFA franc in 2015. As a consequence, West Africa recorded a rise in the inflation rate from 7.5 per cent in 2014 to 8.6 per cent. Public spending in Nigeria, and the currency depreciations in Ghana and Nigeria, also contributed to the inflationary pressures in the subregion.

Figure 9
Inflation rate by subregion, 2014-2016



Note: North Africa excludes Libya.
Source: United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

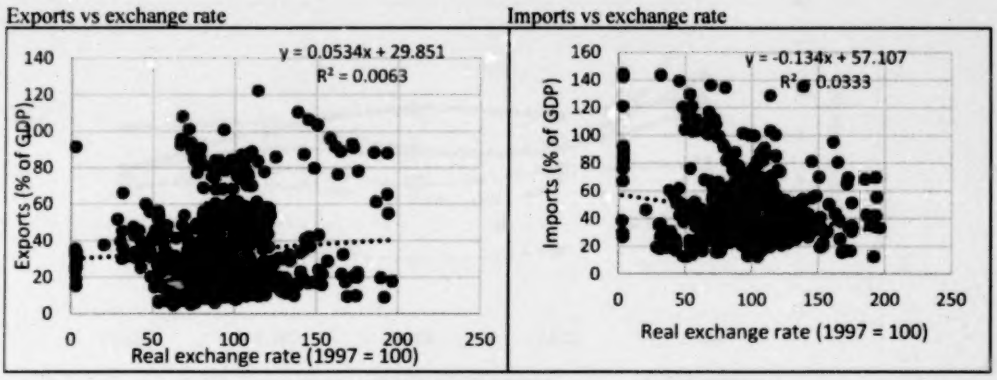
G. Exchange rates continued to depreciate, although with minimal impact on exports

33. Most African currencies depreciated in 2015, a trend that started in 2014. This was driven partly by low oil prices, but also the strong dollar and the expected tightening of the United States monetary policy.

34. Currency depreciation is expected to be associated with increased exports and a decrease in imports. However, figure 10 shows that for African countries the association between exchange rate and trade seems to be very weak and, in some countries, not in line with the theory.[5] This could suggest that there are other factors behind Africa's lack of competitiveness, which undermine the benefits brought about by currency depreciation. While the cost of doing business in Africa has been decreasing, there are still considerable barriers to enhancing Africa's trade,[6] suggesting a lack of product diversification and value addition.

[5] An increase in the exchange rate index indicates an appreciation of the currency.
[6] According to the Ease of Doing Business ranking, the best performing African country, Mauritius, is ranked 32 and only eight African countries are included in the best performing 100 countries (http://www.doingbusiness.org/rankings).

Figure 10
Real exchange rate and exports/imports of goods and services as a percentage of GDP, Africa, 2000-2014

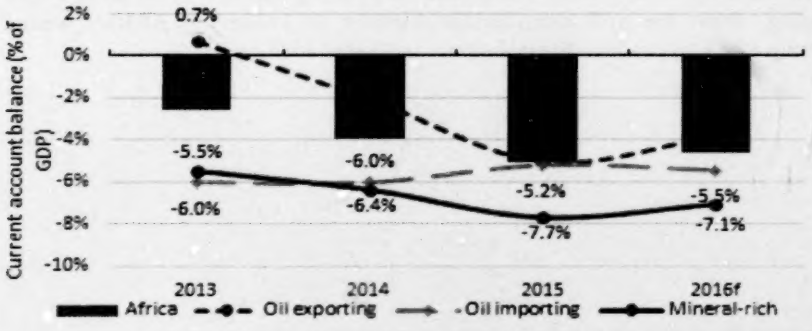

Exports vs exchange rate
y = 0.0534x + 29.851
R² = 0.0063
Exports (% of GDP)
Real exchange rate (1997 = 100)
Imports vs exchange rate
y = -0.134x + 57.107
R² = 0.0333
Imports (% of GDP)
Real exchange rate (1997 = 100)

Source: Analysis based on World Bank, World Development Indicators (databases), 2015.

H. Current account deficits recorded by all economic groupings and subregions

35. Current account deficits increased from -3.9 per cent in 2014 to -5.0 per cent of GDP in 2015, with all economic groupings and subregions reporting deficits (see figure 11). Declining commodity prices and global demand as a result of the global economic slowdown, especially in emerging economies, played a significant role in the current account trends, with oil-exporting African countries recording their first current account deficit since 2009 (2.1 per cent) in 2014, followed by a deficit of 5.1 per cent in 2015. For oil importers, the low oil prices led to a narrowing of the deficit. Of the subregions, the current account deficit was largest for Central Africa (8.1 per cent), followed by East Africa (7.4 per cent) and then Southern Africa (5.7 per cent).

Figure 11
Current account balance, 2013-2016



Note: f = forecast.
Source: ECA calculations based on Economist Intelligence Unit country data, 2015.

36. Africa's total exports of goods and services declined by 3.2 per cent in 2013 and 5.2 per cent in 2014, while its total imports grew by 3.0 per cent in 2013 and by 1.7 per cent in 2014. The continent's total imports are dominated by consumer goods, whereas its exports consist mainly of primary commodities, including fuels and bituminous minerals, and agricultural products such as cocoa, fruits, fertilizers and vegetables. In terms of value, in 2014 fuel exports decreased by 13.2 per cent, and ore and metal exports by 8.2 per cent. On a positive note, whereas Africa's exports to most of its trading partners have stagnated or even declined since the 2008 financial and economic crises, intra-African trade has since then increased considerably in terms of both volume and diversification of manufactured products and services.[7]

I. Stable FDI with declining reserves and increasing net debt among African countries

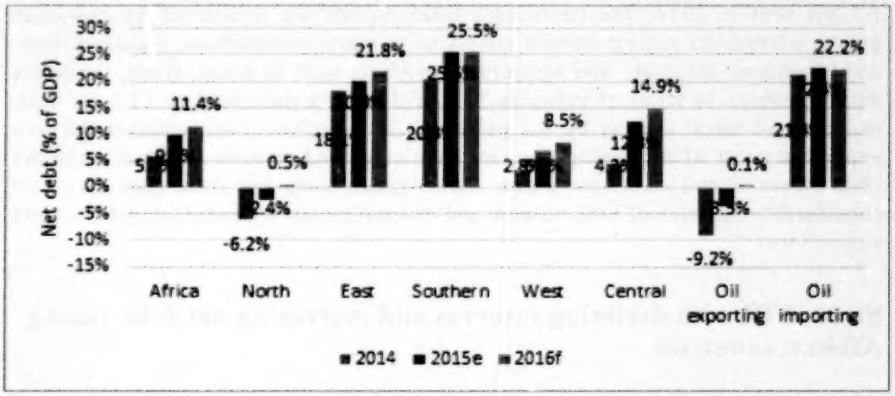
37. African countries saw FDI remain stable at around 3 per cent of GDP in 2015, and are expected to remain at this level in 2016 and 2017. The recovery in North Africa was reflected in the pickup in FDI inflows from 1.4 per cent in 2014 to 1.7 per cent in 2015. Southern Africa (in particular, Angola, Mozambique, South Africa and Zambia) and Central Africa have been the main destinations for FDI. East Africa (particularly Ethiopia, Kenya and Tanzania) also attracted a significant amount of investment, especially in infrastructure.

38. In terms of business function, manufacturing represents 33.0 per cent of FDI, while extraction remains at 26.0 per cent and construction at 14.0 per cent of FDI. By sector however, coal, oil and natural gas dominate at 38.0 per cent of FDI. Therefore, there is still scope for diversification from primary commodities and construction-related investments. FDI into Africa has partly been driven by strong economic growth in key economies, but also the low interest rates in the United States and Europe in 2015, which led to an increase in the flow of FDI into emerging economies. However, with the expectations of monetary tightening by the United States (which finally took place in December 2015), FDI inflows may have started being diverted back to mature markets.

39. The falling oil and commodity prices drew down the international reserves of African countries from 17.1 per cent of GDP in 2014 to 15.8 per cent of GDP in 2015. The oil price decline also affected the net debt of African economies, which increased from 5.8 per cent to 9.9 per cent of GDP between 2014 and 2015, compared to 1.6 per cent in 2013, and is projected to rise further to 11.4 per cent in 2016 (see figure 12).

[7] ECA, *Economic Report on Africa 2015: Industrializing through Trade* (Addis Ababa, 2015).

Figure 12
Net debt in Africa, 2014-2016

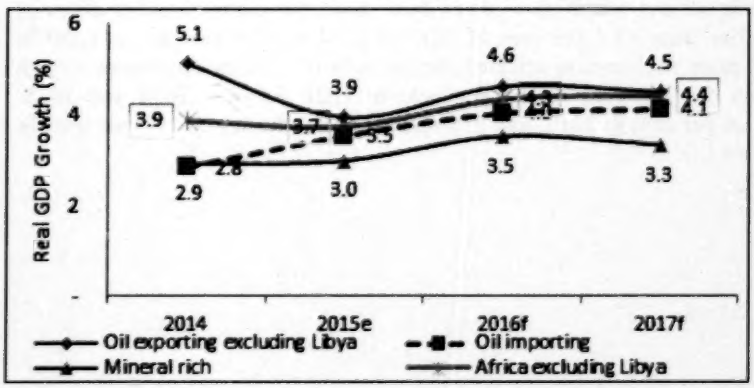


Source: ECA calculation based on Economist Intelligence Unit country data, 2015.

J. Medium-term growth prospects and risks

40. Looking forward, Africa's real GDP growth is expected to increase to 4.3 per cent in 2016 and 4.4 per cent in 2017 (see figure 13). Growth continues to be driven by strong domestic demand (particularly investment in infrastructure). The improving business environment, lower costs of doing business and better macroeconomic management continue to enhance investment. The buoyant services sector and a focus on non-oil sectors by oil-exporting economies in order to mitigate the continued decline in oil prices will contribute to the good medium-term prospects. Further, the increasing trade and investment ties within Africa and with emerging economies, as well as the recovery of traditional export markets, particularly in the eurozone, will positively contribute to the medium-term prospects.

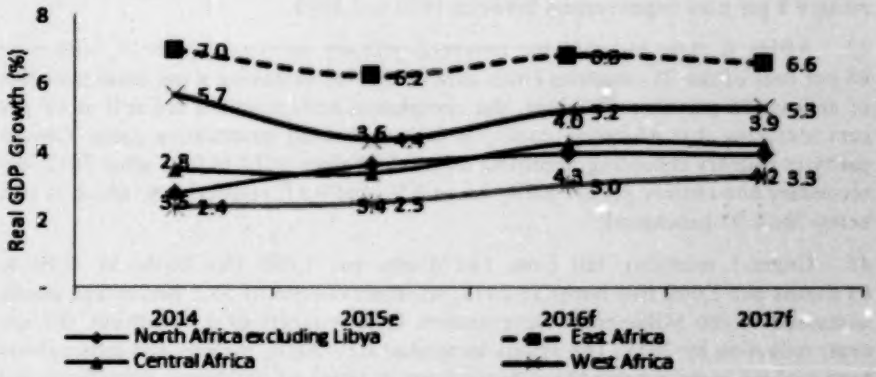
Figure 13
Africa's growth prospects by country grouping, 2014-2017



Note: e = estimates; f = forecasts.
Source: ECA calculations based on data from United Nations, Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

41. At the subregional level, Southern Africa and West Africa are expected to experience relatively high real GDP growth both in 2016 and 2017; while real GDP growth in Central, East and North Africa is forecasted to increase in 2016, but with a slight decline in 2017 (see figure 14).

Figure 14
Africa's growth prospects by subregion, 2014-2017



Note: e = estimates; f = forecasts.
Source: ECA calculations based on data from United Nations Department of Economic and Social Affairs, *World Economic Situation and Prospects 2015* (2015).

42. However, African economies face significant risks that require special attention by policymakers to maintain the requisite growth. More importantly, the turbulence in the global economy has been underpinned by severe financial instability, widening sovereign-debt problems and high unemployment, especially in developed economies. Africa's vulnerability to these shocks calls for a rethink of its growth and broader development strategy.

43. Weather-related shocks, such as drought in East and some parts of Southern Africa in particular, pose a challenge to the agricultural sector, which is still the main employer in most African countries. Low harvests will also increase the risk of inflation through higher food prices in the affected countries. These dry spells may also affect the hydropower generation capacity in the affected countries, hence posing a threat to the greening of Africa's industrialization, as economic agents may switch to thermal electricity power generation that is not green.

44. Security concerns and political unrest in some countries also remain an issue as they can lead to domestic disruption and decreased investment in these countries.

IV. Recent social developments in Africa

45. Africa made considerable progress towards achieving the Millennium Development Goals despite challenging initial conditions. The baseline, generally 1990 for most of the Millennium Development Goals, was relatively low compared to other developing regions. There is an overall positive direction, with significant

proportions of progress with variation across certain goals, across and within countries.

A. Status of progress towards social outcomes in Africa

46. In Africa (excluding North Africa), poverty levels have dropped, although at a slow pace, from 56.5 per cent to 48.4 per cent between 1990 and 2010.[8] The proportion of Africa's population facing hunger and malnutrition demonstrated a meagre 8 per cent improvement between 1990 and 2013.

47. Africa is close to achieving universal primary enrolment in 2013, with over 68 per cent of the 25 countries (with data available) achieving a net enrolment rate of at least 75 per cent. However, the completion rates reported are still at 67 per cent, denoting that education quality is lagging behind quantitative gains. Gender parity in primary schooling improved from 0.86 before 2012 to 0.93 after 2012, but secondary and tertiary gender parity are at 0.91 and 0.87, respectively, which is still below the 0.93 benchmark.[9]

48. Under-5 mortality fell from 146 deaths per 1,000 live births in 1990 to 65 deaths per 1,000 live births in 2012, an improvement of 55.5 percentage points compared to the Millennium Development Goal 4 target of a two-thirds (67 per cent) reduction by 2015. The efforts to combat HIV/AIDs, malaria and tuberculosis have yielded some noteworthy achievements in terms of incidence, prevalence and mortality rates.

49. Progress towards the environmental goal has been somewhat lacklustre. Only a quarter of Africa's population have gained access to improved drinking water sources, which is the lowest proportion globally.[8] Similarly, the proportion of people with access to improved sanitation has increased from 24 per cent in 1990 to 30 per cent in 2012. However, the disaggregated figure of both improved access to water and sanitation is skewed towards urban areas. The inadequate attention paid to rural areas and communities in terms of rural infrastructure combined with population growth results in land degradation, decreasing agricultural productivity, lower incomes and reduced food security.[10]

50. Despite the good progress registered, there are inequities based on income, gender, ethnicity and location. In terms of the human development index (HDI), which measures average achievements in three basic dimensions of human development, a long and healthy life, knowledge and a decent standard of living, most African countries are in the lower ranks of human development. The inequality-adjusted HDI value dropped by 33 per cent in 2015, the highest drop globally (see table 1).

[8] ECA. "Demographic Profile of Africa", mimeo (Addis Ababa, 2015).
[9] United Nations Department of Public Information, *Millennium Development Goals Report 2015* (New York, 2015).
[10] United Nations Environment Programme, *Global Environment Outlook 5* (Paris, 2008).

Table 1
HDI and inequality-adjusted HDI for selected regions

	HDI value	*Inequality-Adjusted HDI value*	*Drop due to inequality (per cent)*
Africa, excluding North Africa	0.518	0.345	33.3
Latin America	0.748	0.570	23.7
South Asia	0.607	0.433	28.7

Source: United Nations Development Programme, *Human Development Report 2015* (2015).

B. Employment mostly generated outside the formal economy

51. Unemployment rates for Africa (excluding North Africa), disaggregated by sex, were 6.9 per cent for males and 8.8 per cent for females in 2014,[11] which represent marginal declines of 0.2 and 0.1 percentage points over the 2009 rates. Notably, economic growth has not kept pace with employment growth, largely because growth has been driven predominantly by capital-intensive sectors such as mining and oil, and the export of primary commodities with little value addition, among others.

52. Most jobs in Africa, particularly for the youth and women, continue to be generated outside the formal economy, where the skills profile is predominantly poor. It is further observed that 9 in 10 rural and urban workers in Africa have informal jobs, and most employees are women and the youth.

53. Over the next 10 years, at best only one in four youths will find a wage job, and only a small fraction of those jobs will be "formal" in modern enterprises.[12] Thus, the informal economy is the major source of employment on the continent, accounting for nearly 70 per cent in East, Central, Southern and West Africa, and 62 per cent in North Africa.

C. However, the working-age population is growing more rapidly

54. The active working-age population (25-64 years) is growing more rapidly than any other age group, more than tripling in size between 1980 and 2015, when it stood at 123.7 million (33.3 per cent) and 425.7 million (36.5 per cent), respectively. The active working group is largely composed of young people, and its growth over time is a feature of the demographic dividend that could lead to productivity gains and economic growth in Africa. The demographic dividend depends on the young population having the right skills profile to secure the positive effects.

[11] International Labour Organization, *World employment and social outlook: Trends 2015* (2015).
[12] African Development Bank. "Recognizing Africa's Informal Sector" (2013). Available from http://www.afdb.org/en/blogs/afdb-championing-inclusive-growth-across-africa/post/recognizing-africas-informal-sector-11645/

D. Africa will have the highest urban growth rate

55. Over the period 2015-2020, Africa will experience the highest rate of urban growth globally, with a rate of 3.42 per cent annually compared to the world rate of 1.84 per cent over the same period. The percentage of Africa's population that is urban increased from 27 per cent in 1980 to 40 per cent in 2015, and is expected to pass the 50 per cent mark by 2035.[13] This will be accompanied by a considerable rise in demand for urban services, infrastructure and employment, all of which are already severely constrained.

56. Beyond the demographic shift, urban areas currently contribute more than 55 per cent of African GDP.[14] The economic role of cities, however, is largely driven by consumption rather than production. Unlike other parts of the world, urbanization in Africa is not linked to industrialization, which in turn has led to "consumption cities" that are populated primarily by workers in non-tradable services.[15] Moreover, African cities remain largely informal. This is particularly problematic given the youth bulge in the region, and the concomitant need to create decent jobs.

57. Urban growth in Africa is also expected to be accompanied by increased energy and resource demands, with the associated impacts on ecosystems supporting urban areas. Globally, urban areas account for over 70 per cent of greenhouse gas emissions.[16] African cities have comparatively lower carbon dioxide emissions, but this is projected to increase significantly in the absence of strategies for urban resource and energy efficiency.[17] Evidence points to the importance of decoupling at the city level to reduce environmental impacts and enhance resource efficiency and productivity, especially by promoting compact cities.[18] As the least urbanized region globally, Africa has a unique opportunity to minimize the carbon footprint of its cities through infrastructure and land use practices that promote density and reduced car-dependence and fossil fuel energy consumption.

58. Given the growing demographic, economic and environmental significance of urban growth in Africa, cities need to be accounted for in the continent's green economy agenda. In particular, urban agglomeration leads to resource efficiency and economies of scale in industrial production through intra-industry and inter-industry

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[13] ECA and United Nations Environment Programme, *BRICS-Africa Partnership for Development: Driving Inclusive Growth and Transformational Change* (2014). Available at http://www.uneca.org/sites/default/files/PublicationFiles/africa-brics_2014_fin.pdf.

[14] African Development Bank. Urban Development Strategy: Transforming Africa's Cities and Towns into Engines of Economic Growth and Social Development (2012). Available from http://www.afdb.org/fileadmin/uploads/afdb/Documents/Policy-Documents/Urban-Development%20Strategy-Rev%201.pdf.

[15] D. Gollin, R. Jedwab and D.Vollrath. Urbanization with or without industrialization. Background paper, April 2014, presented at World Bank-George Washington University Conference on Urbanization and Poverty Reduction (2014).

[16] United Nations Human Settlements Programme, *Urban Patterns for a Green Economy: Working with Nature (2012)*.

[17] N. Godfrey and Xiao Zhao. "The Contribution of African Cities to the Economy and Climate: Population, Economic Growth and Carbon Emission Dynamics" (2015). Available from http://2015.newclimateeconomy.report/wp-content/uploads/2015/09/NCE-African-Cities-Economy-Climate_technical-note.pdf.

[18] United Nations Environment Programme, *City-Level Decoupling: Urban resource flows and the governance of infrastructure transitions* (2013).

interactions. If it is to be resource- and energy-efficient, Africa's industrialization requires an efficient framework of urban centres that produce industrial goods and high value services, along with transportation networks to link national economies with regional and global markets. Greening Africa's industrialization thus needs to be linked to the urban transition underway in the region.

V. Policy implications

59. African countries have made notable gains in improving their regional business environment. Together with the increased economic and political stability across most subregions, these gains have supported growth through enhancement of private consumption and increased public and private investment. However, the recent commodity price developments have highlighted the persistent structural weaknesses of many economies, particularly in terms of government revenue, exchange rates and current account balances. This calls for a stronger emphasis on strategic non-oil sectors, such as electricity, construction and technology, particularly in economies heavily dependent on oil revenue.

60. The global economic environment has increased the need for prudent and counter-cyclical macroeconomic management strategies. The continued low prices offer an opportunity for improved fiscal management and consolidation through the cutting of utility subsidies. Expenditure should instead be targeting high-priority sectors with emphasis on strategic non-oil sectors for accelerated structural transformation.

61. With Africa's continued exportation of commodities, the current global economic slowdown underscores the need for Africa to figure out how it could extract more value from its global trade and other economic activities. Given the more diversified nature of trade between African countries relative to trade with the rest of the world, intra-African trade provides an opportunity for diversification of production. At the same time, diversification of trade patterns can also be a source of improved resilience to external shocks. African countries should seek to enhance intra-African trade by strengthening regional integration, lowering the cost of trade and non-physical barriers to trade, and making a strong commitment to the continental free trade area that is under negotiation.

62. Economic growth rates have been higher in Africa compared to most regions in the last decade; however, in many African countries growth has not been inclusive, the number of Africans in absolute poverty has risen and inequality remains a major concern. This is mostly because Africa's economic growth has been associated with increased exploitation of non-renewable natural resources with minimal value addition and employment generation, which undermines its growth sustainability.

63. The growth of an unplanned urban Africa with a youthful population needs to be matched with an industrialization process that provides the skills demanded and efficient and adequate public services delivery. The focus on the current, largely young and female, informal sector workers to drive the new agenda is a vital aspect of an industrialization process. It is feasible to increase productivity and contribute to improved welfare in the informal sector by providing training, access to credit and social protection.

64. As most African economies are based on agriculture, a sector dependent on rainfall, they are vulnerable to climate variability. Given that sustainability has been placed at centre stage in the process of industrialization, environmental standards should be seen not as an obstacle to competitiveness, but as a potential driver of growth. Africa must improve its resilience to both environmental and socioeconomic shocks, manage its natural capital and minimize pollution, all of which can be achieved by greening its industrialization process.

65. The continent's industrialization and broader development has been held back by erratic energy supplies. The importance of reliable and sustainable energy sources for structural transformation cannot be overemphasized. Africa must tap into and use renewable energy resources to avoid the mistake that developed countries made by not taking into consideration renewable energy issues.

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Summary of the *Economic and Social Survey of Asia and the Pacific 2016*

Note by the Secretary-General

The Secretary-General has the honour to transmit herewith a summary of the *Economic and Social Survey of Asia and the Pacific 2016*.

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Summary of the *Economic and Social Survey of Asia and the Pacific 2016*

[Original: Chinese, English, French and Russian]

Summary

The pace of economic expansion in Asia and the Pacific has decelerated considerably in recent years and, clouded by uncertainty, is expected to plateau at around 5 per cent for 2016 and 2017. Although sluggish exports contributed significantly, this slowdown also reflects moderating domestic demand. A confluence of downside risks may threaten even this relatively moderate pace of growth. Key risks discussed in the *Economic and Social Survey of Asia and the Pacific 2016* are: a somewhat uncertain outlook for the Chinese economy against the backdrop of fragile global economic recovery; volatility in exchange rates, partly due to low oil prices for commodity exporters; growing private household and corporate debt; and an ambiguous path of interest rate increases to be pursued by the United States of America.

Taking advantage of low inflation, many economies have lowered interest rates to support growth. However, the Survey argues that further loosening will be difficult because of capital outflow and financial stability considerations. While many Governments have sufficient fiscal space to scale up development expenditures in areas such as education, health and infrastructure, they also need to expand their tax bases, particularly as stronger fiscal positions will be required to cope with the consequences of economic slowdown for poverty, inequality and employment prospects.

The *Survey* also highlights that multifaceted challenges arising as a result of the rising middle class and rapid urbanization in the Asia-Pacific region will test the capacities of Governments to revive economic growth and pursue sustainable development.

To bolster Asia-Pacific economic growth and effectively pursue the 2030 Agenda for Sustainable Development, the Survey makes the important point that the Governments will need to give higher priority to domestic and regional demand. Raising domestic demand will require higher levels of productivity and commensurate increases in real wages. Strengthening productivity will also contribute to the success of a number of the Sustainable Development Goals. At the same time, investing in achievement of the Sustainable Development Goals will also nurture productivity growth, creating a virtuous cycle between sustainable development, productivity and economic growth.

Emphasizing the need for higher labour productivity in agriculture, the *Survey* underscores the importance of industrialization, especially in rural areas. It cautions developing economies in terms of their rapid transformation towards the services sector and leapfrogging of manufacturing and contains numerous proposals to increase productivity, including an emphasis on the importance of high-quality education to promote innovation and enhance skills.

I. Introduction

1. Inclusive and sustainable economic growth is essential for the success of the 2030 Agenda for Sustainable Development. Robust and consistent economic performance is also necessary to implement the Addis Ababa Action Agenda of the Third International Conference on Financing for Development and the Paris Agreement under the United Nations Framework Convention on Climate Change. The pace of economic expansion in Asia and the Pacific has, however, decelerated considerably in recent years. Therefore, reviving economic growth is vital to implement these three transformative and universal new global agreements.

2. The *Economic and Social Survey of Asia and the Pacific 2016* highlights the importance of increasing productivity to reinvigorate economic growth and support sustainable development. It provides a detailed analysis of factors that have caused the recent economic and productivity slowdown in the Asia-Pacific region, and examines their implications for poverty, inequality and employment prospects. The key macroeconomic risks include: a somewhat uncertain outlook for the Chinese economy against the backdrop of fragile global economic recovery; volatility in exchange rates, partly due to low oil prices for commodity exporters; growing private household and corporate debt; and an ambiguous path of interest rate increases to be pursued by the United States of America.

3. The *Survey* also explores the issues of the rising middle class and rapid urbanization as examples of multifaceted challenges to sustainable development, and to illustrate opportunities to revive economic growth led by domestic demand. To reflect the diversity of the Asia-Pacific region, it provides a disaggregated analysis of economic issues and challenges that each of the five subregions is facing, thereby providing an opportunity to learn from a variety of experiences and policy considerations. This includes challenges relating to population ageing and pension financing in East and North-East Asia, economic diversification and development of the services sector in North and Central Asia, natural disasters and risk-sharing mechanisms in the Pacific, female labour-force participation in South and South-West Asia, and tax policy and administration reforms in South-East Asia.

4. To bolster Asia-Pacific economic growth in light of the fragile global economic conditions, the *Survey* argues that higher priority be given to stimulating domestic and regional demand, and that raising domestic demand will require higher levels of productivity and commensurate increases in real wages. While strengthening productivity will contribute to the success of a number of the Sustainable Development Goals, investing in achievement of the Goals will also nurture productivity growth, creating a virtuous cycle between sustainable development, productivity and economic growth.

II. Implications of recent economic slowdown and outlook

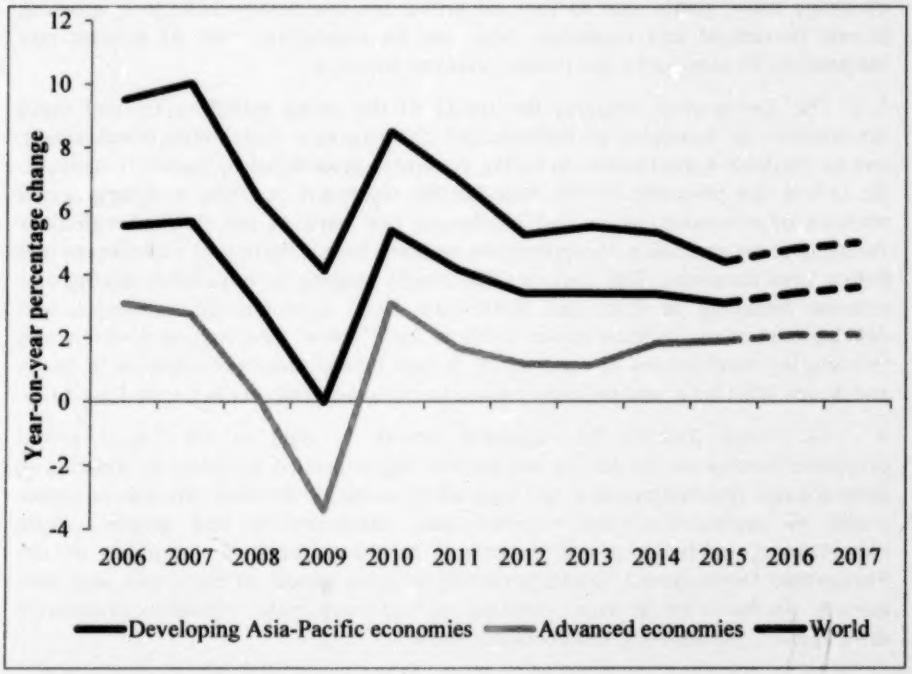
A. Economic growth dynamics

5. The economic growth outlook for the developing economies of the region is broadly stable but is clouded with uncertainty. Against an estimated increase of 4.6 per cent in 2015, economic growth in 2016 and 2017 is forecast to increase marginally to 4.8 per cent and 5 per cent respectively. The reason for the lack of

significant uptick in growth forecast is the expected continuation of a number of factors buffeting the region. Important among them are: the fragile global economic recovery in most developed economies; a continued slowdown in the Chinese economy; weak consumption and investment trends in major Asia-Pacific economies; and declining trends in labour and total factor productivity.

6. Given the export-led growth orientation of many developing economies of the Asia-Pacific region, the fragile recovery in the advanced economies is an important factor holding back faster economic growth (see figure I). With the outlook for the European Union and Japan continuing to remain weak, alongside a somewhat better expected growth performance in the United States of America, prospects of an export-led recovery in developing Asia-Pacific economies will broadly remain subdued. Particularly affected would be the manufacturing export-dependent economies of East and North-East Asia and South-East Asia.

Figure I
Growth in developing Asia-Pacific economies and major global developed economies, 2006-2017



Source: ESCAP forecasts and International Monetary Fund, World Economic Outlook Databases. Available from www.imf.org/external/data.htm.

Note: Developing Asia and the Pacific group comprises of economies of the ESCAP region excluding Australia, Japan and New Zealand. Advanced economies group includes the European Union, the United States as well as Australia, Japan and New Zealand.

7. The slowing of the Chinese economy is the other major external challenge for exporting economies of the region. Given the large weight of China in the gross domestic product (GDP) of the developing Asia-Pacific region — 40 per cent of the total — even a small change in its GDP growth has a considerable impact on the

region's growth. The slowdown in China has been partly driven by a much-needed rebalancing to sustain growth in the medium term, away from investment and net exports towards consumption, as well as away from manufacturing and towards services. It is expected that the Government will maintain its policy focus on rebalancing in coming years, provided the growth slowdown remains gradual. This implies that monetary policy as well as fiscal policy will remain relatively restricted with regard to supporting investment.

8. The developments in China are having manifold impacts on growth prospects of other developing economies in the region. One direct impact is on the real sector through trade linkages with China. A slowdown in economic growth in China results in lower demand for intermediate products for processing and onward export from China as well as for products that help meet final demand in China. A second impact on trade comes from weakening of the Chinese currency. This affects exports by the region's economies to main trading partners because of greater currency competition. Moreover, depreciation of the Chinese currency puts pressure on other currencies in the region to depreciate as well. A decline in the Chinese currency, however, is not the only spur to currency competition. Depreciation of the Japanese currency, given its large export sector, has also played a role in recent exchange-rate depreciations observed in the region.

9. Taken together, the slowdown in China and weak global economic growth have had a particularly strong impact on commodity-dependent economies. Global commodity prices have declined to levels last seen at the time of the global financial and economic crisis of 2008, with the most dramatic reductions in the case of oil. Although global demand and supply factors have played an important role in explaining these declines, the new and most pressing driver in the past year has been concern over the prospects of the Chinese economy. The major commodity-dependent subregion in Asia-Pacific, which has been particularly hit by the slowdown in commodities demand, is North and Central Asia, while Indonesia, Malaysia and Mongolia are the major economies from other subregions that are being negatively affected. Economies where commodities play a major role in exports have seen the greatest declines in their GDP growth between 2014 and 2015.

10. Given the weaknesses emanating from external conditions, domestic demand is likely to play a major role in supporting growth in most developing economies of the region. Some support for growth in domestic demand is likely to come from expected progress in reform policies of major developing economies of the region. These measures include simplification of regulatory structures and government infrastructure programs. However, the role of domestic demand is also expected to remain relatively constrained in the baseline scenario. For instance, growth in domestic consumption and investment in some economies is likely to be negatively affected by the relatively high levels of household and corporate debt that have been accumulating at a rapid pace over recent years. Going forward, a larger share of household incomes and corporate earnings will be directed towards debt payments, constraining further impetus to demand. Investment will also continue to be affected by the general uncertainty regarding prospects for the global economy, with investors remaining wary of undertaking long-term decisions, as well as by excess capacity and low utilization rates in some cases.

11. Low interest rates, ample liquidity and increased access to cross-border loans and international capital markets are the main drivers of sharp increases in household and corporate debt. In the wake of the global financial and economic crisis of 2008, debt finance played an important role in sustaining the region's high economic growth. While some of this was desirable, reflecting the region's financial development, events in the past year, such as the depreciation of the Chinese currency and increase in interest rates in the United States of America, have exposed the risks associated with higher debt, in terms of both financial stability and future growth prospects.

12. In order to ensure sustained growth and financial stability, Governments will need to introduce a host of comprehensive measures to address this issue of sharply growing private debt. Policy priorities should include better monitoring of household and corporate liabilities and assets, and effective use of macroprudential and capital-flow management tools. Policymakers could also increase attention to banks' sectoral exposures in addition to overall capital adequacy, while accounting for contingent liabilities on the fiscal side. However, abrupt tightening measures may further constrain the private sector's debt-servicing capacities and increase debt risks across the board. A phased yet comprehensive approach is thus recommended. At the same time, the region's financial development should continue through greater cooperation and integration.

B. Inflation and monetary policy

13. Against this backdrop, inflation in developing Asia-Pacific economies is projected to soften further to 3.7 per cent in 2016, compared to a multi-decade low of 4.1 per cent in 2015. The plunge in global commodity prices, especially of crude oil, mainly account for this decrease. While inflation is low in the region as a whole, there is considerable divergence between subregions and economies, with commodity dependence being an important driver. For instance, in economies with sizeable commodity exports, subdued commodity prices weakened the terms of trade and external account performance, which resulted in significant currency depreciations and higher inflation rates.

14. All things being equal, an overall low-growth, low-inflation environment in the region would suggest that there is further room for an easy monetary policy stance. Indeed, many economies have continued lowering policy interest rates, though this has not really lifted economic growth so far. However, in many economies, considerations relating to financial stability, in the context of high levels of private debt, will influence the conduct of monetary policy. A monetary policy stance that is kept too loose for too long could undermine domestic financial stability because firms and individuals tend to undertake riskier investment decisions, while their balance sheets look stronger than otherwise. The need to strike a balance between the role of monetary policy in supporting economic growth and ensuring financial stability is especially relevant in economies where household and/or corporate debt levels are already relatively high or rising rapidly.

15. In this context, it is worth highlighting the risk emanating from gradual yet expected increases in interest rate in the United States of America. These will put pressure on capital to flow out of the region and, as a consequence, could lead to higher interest rates in the region. The prospect of increase in domestic financing

costs does not bode well for domestic demand growth, especially fixed investment. Yet, if economies choose to maintain interest rates, they may experience higher exchange-rate pressures. It is this tension in policy consideration that is increasing uncertainty, the ultimate detriment to investment.

C. Employment, poverty and inequality

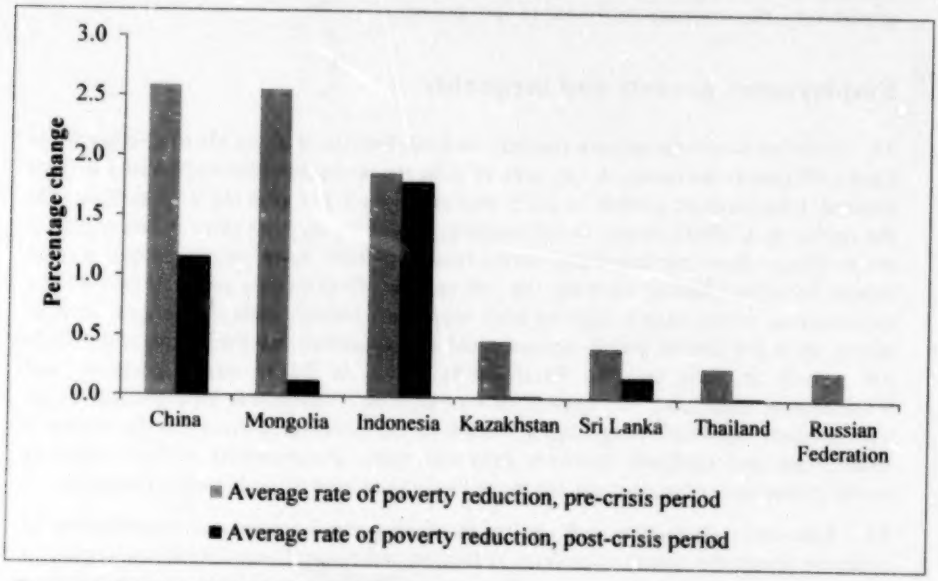
16. Even as economic growth plateaus in Asia-Pacific, it is not clear whether it has been sufficiently inclusive. A key area of concern is the quantity and quality of jobs created. Employment growth in 2015 was merely 1.1 per cent (or 21.3 million) for the region as a whole. A key factor shaping weak employment rates in the region is lower labour-force participation, partly resulting from more young people staying longer in school before entering the job market. Despite this positive part of the explanation, young people who do seek work face considerable challenges, such as taking up a job that is poorly remunerated and underutilizes their potential. While job growth in Asia and the Pacific was muted in 2015, mixed progress was witnessed in enhancing the quality of employment. Vulnerable employment as an own-account or contributing family worker in the developing Asia-Pacific region is widespread and typically involves informal work arrangements without legal or social protection. Also, women are more likely than men to be in vulnerable jobs.

17. Economic slowdown and challenges facing employment are contributing to concerns about the extent of poverty reduction and rising inequality in the region in recent years. Inclusive growth requires not only robust economic growth but also economic expansion that reaches the poorer sections of the population and assuages inequality. Available data indicates that some major developing economies in the region, accounting for a large proportion of the population in Asia and the Pacific, have seen a decelerating trend in the rate of poverty reduction in the post-crisis period as compared to the recent pre-crisis period (see figure II). Similarly, indicators of income inequality, whether gauged through Gini coefficients or the Palma index, seem to have worsened in recent years.

18. Apart from the direct impact of decelerating growth, an important driver of slowing poverty reduction and rising inequality in the post-crisis period is the underlying nature of the growth model itself, which essentially favours unfettered consumption-led debt-fuelled increases in economic output. There is nothing inherently wrong with consumption-led economic expansion. The problem emerges when a large segment of the population, especially the lower income groups, increasingly and excessively rely on debt rather than wages to support increases in consumption. This may be as a result of the outpacing of wage growth by productivity increases that many developing economies of the region have seen in recent years, and that has led to a shift in the balance between labour and capital shares in national income, resulting in unequal distribution of incomes favouring the latter.

Figure II

Average rate of reduction of the poverty headcount ratio at $1.90 a day in selected Asia-Pacific economies, pre-crisis and post-crisis periods



Source: ESCAP, based on World Development Indicators.

Notes: China 1999-2008 and 2008-2010; Indonesia 1999-2008 and 2008-2010; Kazakhstan 1996-2008 and 2008-2013; Mongolia 1998-2007 and 2010-2012; Russian Federation 2000-2008 and 2008-2012; Sri Lanka 1995-2006 and 2009-2012; Thailand 2000-2008 and 2008-2012.

19. Thus, ensuring consistent increases in wages is important for reducing poverty and inequality as the poor are more often employed in wage-earning sectors, as compared to the more well-off who rely more on non-wage income sources. A productivity-driven wage-led approach to economic growth is therefore preferable, as it has a higher chance of addressing issues of poverty and inequality, in addition to supporting sustained increases in economic growth. Moreover, slow progress in reducing poverty as well as growing inequality has further underscored the pressing need for greater social protection in the region. Apart from the need to ensure inclusive and sustainable development, greater social protection will also support regional economies in boosting the role of domestic demand in growth by reducing precautionary savings for emergencies, especially by the poor.

D. Fiscal policy

20. Countercyclical fiscal policy, unlike monetary policy, can potentially play a more supportive role for growth. Indeed, the stance of fiscal policy in the region in 2015 was largely countercyclical and expansionary. Whether fiscal policy aims to stabilize the economy or support national development, an important consideration has to do with fiscal sustainability. By and large, most developing countries in the region have relatively low levels of government debt. Moreover, recognizing that there is no mechanical or universally accepted threshold for limiting public debt,

and that fiscal austerity measures informed by the notion of a unified threshold prompted sharp output declines in Europe, the policy relevance of holding onto a particular threshold has been questioned. Ultimately, each country needs to assess the costs and benefits of higher public debt; for instance, smaller margins to cope with contingent risks against faster achievement of development goals.

21. An important consideration beyond stabilization is the potential impact of fiscal policy on the distribution of income and opportunities and on long-term economic growth. Spending on education, health and infrastructure are particularly important in this regard, and countries are trying to scale up such spending, including through debt financing or sales of certain state assets, as well as the reallocation of expenditures and improved revenue collection. However, aside from financing, it is important to improve project selection and management and implementation capacities across the board.

E. Rising middle class and urbanization

22. Despite the slowdown of recent years, faster growth in the previous decades has resulted in a noticeable increase in the middle class in many countries of the region. This has created both specific opportunities and numerous challenges. On the positive side, the middle class offers an increasing pool of domestic demand to be tapped by economies, thus reducing their dependence on the struggling external sector. A rising middle class, with higher disposable income, tends, however, to demand public services that go beyond basic needs, such as access to better quality education, health, water and recreational services along with reliable energy and information and communications technology infrastructure. This puts pressure on Governments to provide these services and, in case of expectation gaps, can lead to social tensions.

23. Managing changing consumption and production patterns and air pollution and congestion related to increasing vehicle use are other examples of challenges associated with a growing middle class. It is worth noting that in societies with high income inequality, the group earning just above $2 a day is still at the bottom of the income distribution and remains very vulnerable to falling back into poverty because of external shocks such as a persistent decline in economic growth, weaker employment prospects and natural calamities. They are considered a "transitional class" and require consistent support to strengthen their resilience. Governments will therefore need to ensure that social protection is provided for this group in particular in order to cement their position in the middle-class category.

24. A particular feature of the rise of the middle class, and the wider economic growth process in the region, is the phenomenon of rapid urbanization. This process has led to a large movement of the poor to cities and a rapid increase of the middle class in cities. Despite the positive contribution of cities to growth, not all urban dwellers have benefited from this transformation. In many cities, the majority of the urban population continues to rely on the informal sector for employment, housing and access to land, basic services such as safe water supply and transport facilities.

25. Dealing with these challenges and changing dynamics requires specific government policies. One approach is to redirect urbanization to emerging smaller cities and simultaneously enhance rural-urban linkages to move towards more balanced urbanization. Another part of the solution is to take action within existing

cities to reorient consumption patterns, develop the necessary infrastructure and improve social support structures. An important aspect of undertaking such proactive policies will be tackling the issue of insufficient local government funding. Moreover, many of the region's cities are managed with outdated legal and regulatory frameworks and institutional arrangements.

26. Rapid urbanization in Asia and the Pacific region has also significantly raised its exposure to natural hazards by exacerbating existing risks and creating new ones. Many cities in the region are outgrowing their capacity of basic service delivery, and thus exposing city dwellers, particularly those in slum areas, to disaster risk. Climate change and projected sea level rise pose further challenges, especially to coastal cities in which more than half of the region's urban population currently live. Many urban areas in the region are highly vulnerable to disaster since their comparative advantages and economic competitiveness has led to a great concentration of economic and other assets.

III. Perspectives from subregions and their policy challenges

27. In East and North-East Asia, economic slowdown in China and the Republic of Korea together with Japan's weak growth path and stubborn deflationary pressure depressed the subregion's economic expansion in 2015. The near-term economic prospects for this export-oriented subregion are not bright either, as global trade is set to expand only sluggishly in coming years. The Republic of Korea is the only economy in the subregion where growth is set to trend up steadily over 2016 and 2017 amid revived domestic demand. Key uncertainties are whether medium-term growth in China will settle around 6.5 per cent and whether the Japanese economy will return to a recession if consumption tax increases in 2017, as planned. The upside is that in most economies of the subregion there is adequate room for fiscal and monetary policy support.

28. Slower economic growth in China is partly policy-induced. This transition is indeed positive as long as progress that has been made on social development is not reversed. A more challenging situation could arise in neighbouring countries such as Mongolia, which has relied on demand from China for minerals to fuel its economic expansion in the past years. As macroeconomic policy space to cope with slowdown in China is limited, slower growth in Mongolia is perhaps inevitable and could hold back the pace of poverty reduction. More broadly, decelerating growth in China has recently been accompanied by growing concerns and heightened economic uncertainty, as reflected in global stock market sell-offs in mid-2015 and again in early 2016. An immediate challenge is how to manage the transition in China without causing too many negative spillovers to the global economy.

29. Given that economic deceleration in China is already in its sixth year, subregional economies have been seeking to increase the role of domestic demand in driving future economic growth. Despite some concrete policy efforts and examples of success, the adjustment has not been sufficiently rapid. This is largely because the transition is constrained by structural factors that evolve only slowly, such as a shrinking population in Japan, high retention of corporate and personal savings in China and relative neglect of non-export activities in the Republic of Korea.

30. The issue of ageing population poses a serious threat to the economic and social development of the subregion. The size of the working-age population in all major subregional economies is projected to fall after 2020 to the extent that elderly people could account for up to one third of the total population by 2035. The impact of rapid population ageing on fiscal sustainability could be substantial as it pushes up public spending on old-age pension schemes and health-care services while constraining revenue collection as a result of a smaller workforce and a lower savings rate. Although the subregion appears to exhibit adequate fiscal resources now, fiscal risks are rising.

31. In North and Central Asia, the subregional economies faced a marked deterioration in economic growth performance and heightened macroeconomic instability in 2015. In most countries, a deep plunge in global prices of oil, gas and minerals slashed export earnings and fiscal revenues, weakened terms of trade, and resulted in steep currency depreciations and multi-year high inflation. International sanctions and stalled progress to tackle structural weaknesses also drove the recession in the Russian Federation. As the Russian labour market employs numerous migrant workers from neighbouring economies, the recession dampened economic growth in non-oil, remittance-dependent subregional economies.

32. Although some analysts suggest that the economic turmoil may have bottomed out, the outlook is highly uncertain and would depend on oil prices and developments on the geopolitical front. Moreover, risks are clearly tilted to the downside. As a large share of bank credits is foreign-currency denominated, debt burdens and overdue loans have surged owing to exchange-rate depreciations, thereby placing financial stability at risk. A key concern is that oil prices are not expected to pick up soon so the pressure that deterred economic growth in 2015 will persist, with relatively less room for policy response as fiscal positions have weakened because of earlier fiscal stimulus and subpar energy revenue and as monetary policy faces a dilemma amid subdued economic growth, high inflation and risk of further currency depreciation. Poverty has recently increased in the Russian Federation and could rise further amid a prolonged period of economic downturn.

33. The current economic turmoil serves as a stark reminder that the subregion needs to diversify its growth engine beyond resource-based sectors. Although infrastructure connectivity has improved in recent years, reforms to create vibrant business-support services to complement a high value-added manufacturing sector are needed. Economic diversification calls for liberalization in both input and product markets. The policy challenge is to push forward deregulation, such as easing market entry, while having in place strong regulatory bodies that protect consumer interests and ensure fair competition. Questions also remain regarding the desirable size and role of public enterprises in driving future economic growth in these economies where the role of state has historically been dominant.

34. In the Pacific, overall economic growth in 2015 was largely driven by higher production of liquefied natural gas in Papua New Guinea, which accounts for 60 per cent of output in Pacific island developing economies. This masks much slower economic expansions and even contractions in other countries. Economic growth has traditionally been volatile, as economic activity was often driven by movements in global prices of primary commodities, tourism receipts that are highly sensitive to economic conditions in source economies, and one-off developments such as natural

disasters and subsequent reconstruction activities. The near-term growth outlook is set to weaken as capital inflows to the mineral sector in Papua New Guinea have passed their peak levels, while dry conditions brought by the El Niño event would constrain subsistence agriculture.

35. Given their small population size and land area and remote geographical location, Pacific island developing countries are highly exposed to natural hazards and meteorological extremes such as cyclones, tsunamis, droughts and floods. The likelihood that a natural disaster will take place in one of the Pacific island developing countries each year is about one in five, which is greater than any other small states in the world. Because of their magnitude, natural disasters seriously threaten the livelihood of people in the Pacific. For example, damage and losses of Cyclone Pam, which hit Vanuatu in March 2015, are estimated at about 60 per cent of the country's gross domestic output. The impact on the poor is even greater, given that they live in more disaster-prone areas with less protected shelters.

36. As exposure to natural catastrophes is largely determined by geographical conditions, public policies have focused on enhancing a country's ability to cope with natural disasters. In this regard, many countries have recorded larger fiscal buffers, while an insurance scheme linked to natural disasters was launched at the subregional level. Other initiatives are also under way, such as the construction of transport infrastructure resilient to natural disasters, and a national budgeting process that recognizes the cross-cutting nature of natural disasters. Nonetheless, the sheer scale of weather-related extremes calls for closer and perhaps more innovative partnerships between the Pacific islands and the international development community.

37. In South and South-West Asia, the economy of India is gradually gaining growth momentum, underpinned by steady yet uneven progress on policy reforms to attract foreign investment and revive stalled infrastructure projects. However, the positive spillovers of stronger growth in India to other major economies in the subregion are small given limited trade and financial linkages. For the near-term outlook, optimistic prospects assume that structural reforms will move forward at a pace that keeps up with public expectations, thus helping to improve market sentiments. As recent interest-rate reductions have not translated into higher fixed investment, it appears that more reforms to enhance the business environment are needed. The role of policy reforms in supporting future economic growth is particularly important for this subregion because room for countercyclical policies is somewhat limited. However, policymakers will need to remain cognizant of the potential negative implications of such reforms for poor people in general and low-skilled workers in particular.

38. Until recently, the subregion had faced three persistent interconnected macroeconomic imbalances, namely large fiscal deficits, high inflation and wide current-account shortfalls. Lower oil prices resulted in a decline in inflation and have allowed fuel-subsidy rationalization, leading to a positive effect on fiscal positions. Nonetheless, reforms to ease supply-side constraints, such as severe energy shortages and infrastructure deficits, are critical in reducing production costs and promoting export competitiveness. Over the medium term, these reforms would help to relieve cost-push inflation and narrow the current-account shortfalls, thus promoting greater macroeconomic stability in the subregion.

39. Despite a recent pickup, the subregion's economic growth remains below its high potential that is supported by a young population and surplus labour in the agricultural sector. One option to close the output gap is to increase the female workforce participation rate, which is quite low compared to other parts of the world. Policy efforts have been made to overcome core barriers to women's work, such as enhancing availability of and access to high-quality education and providing safe public transport to work in rural areas. Other policies are designed to offset disincentives for women to work, such as offering adequate parental and child-related benefits and taxation frameworks that reduce the net tax liability of working mothers. However, the key question is whether these policies are bold enough to alter deep cultural roots and social norms that discourage or even prohibit the role of women outside the household sector.

40. In South-East Asia, economic growth reached a five-year low in 2015. Merchandise exports declined amid the slowdown in China, but household spending in major economies was also held back by domestic factors such as slower job creation in Indonesia and high household debt levels in Malaysia and Thailand. The near-term growth prospects would benefit from the accommodative monetary policy stances and fiscal stimuli recently launched in larger economies. Countries with lower income levels would continue to enjoy relatively robust economic expansion, thus narrowing the development gaps between frontier economies and emerging economies in the subregion.

41. The ASEAN Economic Community became effective in 2015, with the goal of promoting a single market and production base in the subregion. Lower import tariffs and less restrictive non-tariff barriers should provide a good opportunity for countries such as Cambodia, the Lao People's Democratic Republic and Myanmar to diversify their growth engines, although reforms to enhance the business environment are also needed to attract more foreign direct investment. While foreign investment helps to create more jobs, it may not necessarily benefit government revenue to the expected extent because of various tax exemptions and reductions that are in place. These tax privileges also complicate tax administration and result in lower compliance. Such competition across countries in the subregion and beyond to attract more foreign investment by offering generous tax benefits is not always welfare-enhancing, and should be addressed through stronger regional cooperation on tax matters.

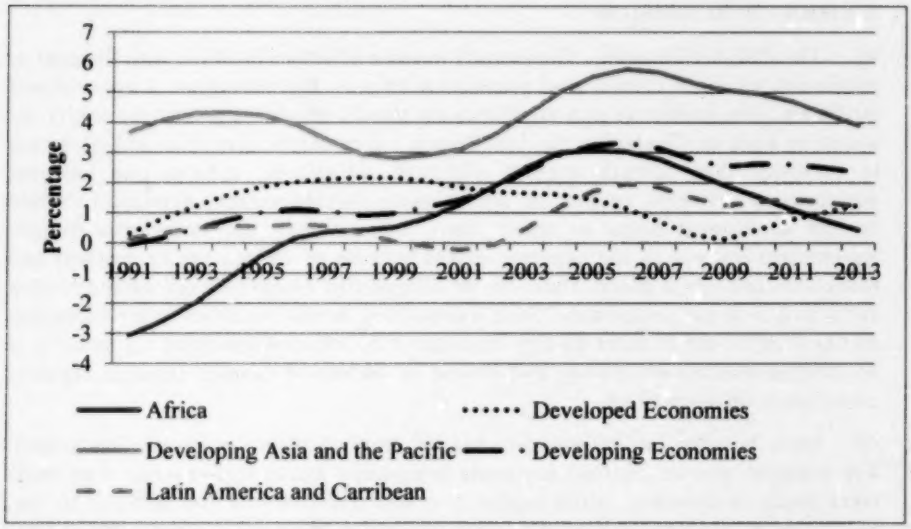
42. More broadly, tax reforms are needed amid changing economic landscapes. For example, greater regional economic integration means that revenue from trade taxes tends to decrease, while capital becomes more mobile and difficult to tax. Moreover, as countries move up the income ladder, there will be more demand for better public social services and urban infrastructure amid a growing middle-class population and rapid urbanization. Critical to a successful tax reform is the need to have more effective coordination among relevant agencies, such as departments within the ministry of finance, foreign investment promotion agency and local governments. Greater use of information technology in tax administration also matters, especially its capacity to help increase tax compliance through risk-based auditing and third-party information-sharing.

IV. The importance of strengthening productivity

A. Analysis of trends in productivity

43. The relatively strong economic growth witnessed in the Asia-Pacific region over the last few decades was primarily driven by factor accumulation; that is, by increases in the labour force and by increases in the capital stock through investment, including from abroad. At the same time, significant increases in productivity, particularly in labour productivity, also took place throughout the region. Indeed, labour productivity growth in developing Asia-Pacific economies has been the highest among developing regions of the world since the 1990s and exceeds that of developed economies by a significant margin. Yet, since the 2008 crisis, it has started to decline (see figure III). Nevertheless, the gap in the level of labour productivity between developing and developed economies has roughly halved, with labour productivity in developed economies being about 12 times higher than that in developing economies in 2013 compared to 24 times higher in 1990.

Figure III
Trend of labour productivity growth by regions



Source: ESCAP calculations, based on data from the ESCAP Online Statistical Database and the World Development Indicators database.

44. While growth rates of total factor productivity in the Asia-Pacific region have also been significantly above those recorded in other regions of the world, they too have declined significantly in the region since the 2008 crisis (see table). One factor that partly explains this slowdown is "labour hoarding" and its impact on efficiency of firms. For instance, during the period from 2007 to 2013, the unemployment rate in several economies of the region remained mostly stable, in comparison with the significant increase that was recorded in developed economies; a higher

employment rate in times of lower demand tends to translate into lower productivity growth.

Table
Average annual growth of total factor productivity across regions

Regions	*1990s*	*2000s*	*2000-2007*	*2008-2014*	*1990-2014*
Developing Asia-Pacific economies	1.41	1.93	2.79	0.96	1.74
Africa	-0.28	0.85	0.28	1.49	0.42
Latin America	0.02	0.07	0.38	-0.29	0.05
Developed economies	0.37	0.32	0.68	-0.09	0.34
Developing economies	1.16	1.64	2.32	0.86	1.46

Source: ESCAP calculations, based on the Penn World Table 8.1, which appears in Robert C. Feenstra, Robert Inklaar and Marcel P. Timmer, "The next generation of the Penn World Table", *American Economic Review*, vol. 105, No. 10 (October 2015). Available from www.rug.nl/research/ggdc/data/pwt/v81/the_next_generation_of_the_penn_world_table.pdf.

45. The declines are worrying as both economic growth and productivity growth play a vital part in development. If unaddressed, these slowdowns will make it more difficult for the region to address its unfinished development agenda, which includes (a) lifting 639 million people, equivalent to two thirds of the global total of extremely poor people, out of poverty, and (b) tackling remaining challenges in the areas of health, education, gender equality, decent employment and access to safe sanitation and drinking water.

46. To bolster economic growth in light of fragile global economic conditions and to make it more inclusive and sustainable, the region should give higher priority to stimulating domestic and regional demand. Fostering domestic demand, however, will require higher levels of productivity and commensurate increases in real wages. Strengthening productivity will also contribute to the success of a number of the Sustainable Development Goals. At the same time, investing in achievement of the Goals will also nurture productivity growth, thereby creating a virtuous cycle between sustainable development, productivity and economic growth.

47. Productivity can be assessed in terms of levels and in terms of growth. It can also be analysed at different levels; for instance, across firms or across sectors, or across the country as a whole. A country that has a higher level of productivity than another one is able to produce more with the same amount of inputs and is thus comparatively more competitive. In contrast, countries with higher productivity growth see larger relative increases in their output than those with lower productivity growth rates. This said, across sectors, industrial/manufacturing productivity tends to grow faster than agricultural productivity due to a variety of factors, including technological change, economies of agglomeration and economies of scale.

48. It is worth noting that as the share of the manufacturing sector in GDP increases, so does aggregate productivity growth, as labour moves from a relatively low productivity sector (such as agriculture) to a higher productivity sector (such as manufacturing). Thus, a rising (or declining) aggregate labour productivity does not necessarily mean that a rising (or declining) contribution is being made by the existing work force in a particular sector. Therefore, rapid growth in aggregate

labour productivity must not be necessarily seen as a positive indicator of development. Rather, the limitations associated with such growth need to be kept in view. For instance, some of the technology imported from developed countries may hold only meagre possibilities of labour absorption as it may suit the labour market conditions of labour-scarce, high-income countries only. With such technology, low levels of labour demand would translate into sluggish employment growth. Thus, the skill bias of modern technology and/or rapid capital accumulation can reduce the pace of absorption of the unskilled labour. This could contribute to stretches of low productivity activities, particularly in the informal sector, by compromising the residual absorption of labour.

49. For instance, agriculture's share in GDP in developing economies of the Asia-Pacific region has declined much faster than the corresponding decline of agriculture in total employment. Specifically, the share of agricultural value added halved between 1990 and 2013, from 19.1 per cent in 1990 to 9.9 per cent in 2013, while the share of agriculture in total employment declined by about 20 percentage points to 36 per cent of the labour force. Large gaps between the two values generally indicate a relatively faster growth of the economy without a corresponding ability to absorb the expanding labour force. Indeed, it could be suggested that a large number of countries in Asia and the Pacific have been unsuccessful in integrating surplus labour into the rest of the economy.

B. Deindustrialization in developing economies

50. Many countries in the region are shifting from an agriculture-based economy to one in which services play a dominant role, leapfrogging the manufacturing stage in their economic transition. Thus, between 1990 and 2013, the share of services in value added increased by a quarter, accounting for more than 53 per cent of total value added, while its share of employment increased by 60 per cent, reaching 37.6 per cent of employment. Moreover, in most developing Asia-Pacific economies, the contribution of the service sector to labour productivity growth was the most important one. The contribution of industry exceeded that of services in Azerbaijan and China only.

51. This shift to services is coming at a too early level of development in many countries in the region and may not be conducive to fostering development. One reason could be that services are not as tradable as manufactured goods; also, services do not usually exhibit the same technological dynamism, which therefore makes them a poor substitute for export-oriented industrialization. Therefore, it is imperative to reindustrialize and to stimulate productivity growth.

52. While countries that have developed successfully, such as the Republic of Korea, have generally done so on the back of rapid industrialization, it is worrying that many developing economies in the region are already deindustrializing. Indeed, when services contributed to half of value added output in developed economies, their levels of income per capita were on average five times higher, in real terms, than is currently the case in developing economies in the region. Moreover, transforming towards a service-based economy may further increase downward pressure on productivity growth in the future since productivity in the service sector is usually lower than that in the industrial sector.

53. Increasing productivity in agriculture and industrializing the rural sector is thus particularly important. With almost four out of ten workers still engaged in agriculture and 55 per cent of the developing region's population living in rural areas, the role of agriculture is vital to strengthening domestic demand. In addition, agriculture is important as the sector provides an important basis for many other activities, including manufacturing. For instance, in several economies, including Pakistan, Indonesia, the Philippines and Viet Nam, food, beverages and tobacco contribute between 20 per cent and 30 per cent of total value added in manufacturing. In Nepal, the contribution is more than a third of total value added in manufacturing and in Fiji it reaches almost a half. Greater labour productivity in agriculture would thus enable higher incomes in the rural sector, which would contribute to strengthening domestic demand and to reindustrializing economies.

C. The nexus between productivity and the Sustainable Development Goals

54. The Sustainable Development Goals provide an entry point to strengthen productivity. At the same time, focusing on productivity provides an overarching framework for countries to tackle the achievement of several Goals, thereby creating a virtuous cycle between the Goals and productivity. It must be recognized, though, that at an early stage of development productivity-driven growth may not be consistent with decent jobs and higher wages.

55. Raising agricultural productivity must be at the centre of focus to end poverty (Goal 1) and end hunger and achieve food security (Goal 2). Increasing productivity, especially in the agriculture sector, contributes to the reduction of poverty directly by positively affecting rural households' income obtained from agricultural and non-agricultural activities. Estimates show that increasing agricultural productivity relatively modestly over the period 2016 to 2030 could lift an additional 110 million people out of poverty in developing countries in the region. Agricultural productivity growth also reduces food insecurity of poor households as household incomes tend to be positively correlated with output per worker in agriculture. Greater agricultural productivity would further contribute to lower food prices, thereby increasing food security and leading to an increase in real consumption, which would be particularly beneficial to poor households.

56. Efforts to eradicate poverty, particularly in the rural sector, and attain Goal 1, as well as to achieve higher levels of productivity in agriculture and ensure the associated higher incomes in the rural sector, would foster development of the rural sector and encourage industrialization (Goal 9). As higher levels of productivity in agriculture will free up labour from that sector, which will be available to work in the non-agricultural sector, it will be important to consider a broader development strategy. A focus on accommodating the agricultural push of labour will provide an opportunity for moving towards full and productive employment and decent work for all to achieve a sustainable and inclusive economic growth (Goal 8). In particular, by encouraging a structural change following an agriculture-industry-service sequence, rural industrialization through small-scale industries could be achieved. Firms in the industrial and service sectors would also be able to benefit from the additional demand resulting from the decreasing number of poor people, and from higher rural incomes.

57. Absorbing the agricultural push of labour will also require additional training, particularly of those with low skills, especially in view of the skill bias in modern technology, which reduces the scope for absorption of unskilled surplus labour. Therefore, mechanisms are needed to ensure that populations have access to quality education and lifelong learning (Goal 4), particularly if full and productive employment is to be provided. Moreover, education needs to be reformed for workers' skills to become and remain relevant to an industrializing framework. This requires emphasizing the lifelong availability of quality education for innovation and productivity.

58. Combating climate change and its impacts (Goal 13) can also have a beneficial impact on productivity growth, especially productivity in the agricultural sector. It is worth highlighting that boosting productivity is generally seen as a predominantly economic concern. Typically, little attention is paid to the efficiency of the economic system in terms of intensity of resource use, particularly energy, and the associated environmental degradation. The current dominant development strategy tends to favour a "grow now, clean up later" approach without assessing the significant socioeconomic and environmental costs; costs most often borne by the most vulnerable in society. The climate change resulting from this approach is negatively affecting productivity growth, indicating the need for a change in development strategy.

D. Policies to increase productivity

59. Given the declining trend in productivity growth and its relationship with the Sustainable Development Goals, countries in the region would benefit from focusing on policies that foster productivity growth and share productivity gains. This would facilitate the pursuit of the Goals as well as improving economic growth prospects. Moreover, by accelerating productivity growth that is supported by increases in real wages, countries may be able to catalyse a shift to a growth model in which domestic and regional factors play a relatively larger role in driving demand. Thus, by focusing on policies that increase productivity, economies can increase the aggregate supply as well as the aggregate demand, while enhancing their societies' well-being.

60. Fostering agricultural productivity and industrializing the rural sector will be key to strengthening domestic demand, and must be at the centre of the effort deployed by Governments. In addition to stimulating economic growth, this will contribute to equity and political stability. Ways to strengthen the role of the rural sector and increase agricultural productivity include diversifying into high-value crops, focusing on quality and standards, developing rural infrastructure such as roads, irrigation and information and communications technology, and strengthening investment in research and development.

61. Although the reallocation of labour and capital across sectors did not play a significant role in labour productivity growth, the issue of large surplus labour in agriculture cannot be solved within the boundaries of agriculture alone. Appropriate strategies and policies are therefore needed that help absorb the push of labour from the agricultural sector and that enable accelerating productivity growth. These policies include developing the non-farm sector by fostering rural industrialization through small-scale industries. This can strengthen linkages between agricultural

and non-agricultural sectors and lead to backward-forward and production-consumption linkages within agriculture and between the agricultural and non-agricultural sectors.

62. Importantly, Governments' policies should facilitate such movements by retraining workers to make them more employable (for example, by training farmers to operate machines, and training industrial workers to improve technical services in rural areas) and offering productivity-based financial incentives for encouraging such movements (by linking gains in productivity more closely to wages, for instance).

63. Strengthening research and development is important to strengthen skills in the labour force. Although expenditure allocated to research and development in the developing region has doubled since the end of the 1990s to 1.4 per cent of GDP, it lags behind developed regions by a wide margin. Another avenue is to expand undergraduate and technical education and strengthen vocational schools. Indeed, the contrast between, on the one hand, the relatively weak rankings of some of the region's economies in the Organization for Economic Cooperation and Development Programme for International Student Assessment* and, on the other, the fact that the developing economies with the highest labour productivity in the region (Singapore; Hong Kong, China; and the Republic of Korea) also rank highest in the Programme highlights the importance of education in providing the skills required to apply current technologies as well as to assimilate, adapt and develop new technologies.

64. Concerning the need to raise productivity in the industrial sector, there needs to be a trade-off between the provision of fiscal incentives and the need to raise more fiscal revenues to strengthen development. Nevertheless, encouraging firms to innovate and conduct research and development activities through fiscal incentives and financial benefits aimed at making industry (in particular, manufacturing) more productive could lead to more efficient, technologically up-to-date, and competitive production. Programmes to upgrade the skills of the workforce, infrastructure-related programmes that refer not only to physical but also to financial and social infrastructure, and efforts to improve accessibility of enterprises to information and communications technology are among the initiatives that could increase the productivity of industry while also spurring spillover effects related to foreign direct investment.

65. Lastly, increases in labour productivity will have to be passed on to workers. To ensure that economies in the region are able to shift to a development model in which domestic and regional demand play a greater role, the decline in the share of labour income in total output needs to be reversed. This will require the linking of gains in labour productivity more closely to commensurate gains in wage levels. To so do, Governments can strengthen the enabling environment for collective bargaining in the region. Minimum wages can also act as an important policy tool to ensure that wage levels are increased. Social protection measures (including unemployment insurance and pensions) would foster domestic demand further, and enable a smoother reallocation of workers between sectors.

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* The Programme for International Student Assessment aims to assess quality, equity and efficiency of school systems so as to evaluate the ability of education systems to provide young people with key knowledge and skills that are essential for full participation in modern societies.